

DON'T BELIEVE THE HYPERLINK—

POTENTIAL LIABILITY OF ISSUERS UNDER ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS FOR EMBEDDING HYPERLINKS TO ANALYSTS' REPORTS ON THEIR WEB SITES

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INTRODUCTION

The Internet¹ offers instantaneous worldwide access to hundreds of millions of computer users, thereby radically changing modern communication systems and, in particular, propelling the securities industry into the 21st century.² Numerous publicly traded corporations have assimilated Web-based technology into their regular business operations and have established their own Internet sites to provide corporate and industry information.³ The company

¹ A formal definition of the term, adopted by resolution of the Federal Networking Council (FNC) on October 24, 1995, states:

"Internet" refers to the global information system that —

- (i) is logically linked together by a globally unique address space based on the Internet Protocol (IP) or its subsequent extensions/follow-ons;
- (ii) is able to support communications using the Transmission Control Protocol/Internet Protocol (TCP/IP) suite or its subsequent extensions/follow-ons, and/or other IP-compatible protocols; and
- (iii) provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described herein.

FNC Resolution: Definition of "Internet", available at http://www.itrd.gov/fnc/Internet_res.html (last modified Oct. 30, 1995).

² Robert B. Robbins, *Regulation of Online Securities Transactions*, SE62 A.L.I.-A.B.A. 445, 447 (2000) (outlining the regulatory issues addressed by the Securities Exchange Commission (SEC) in response to the proliferation of online securities trading and access to issuer information).

³ Use of Electronic Media, Securities Exchange Act of 1934, Securities Act of 1933, Investment Company Act of 1940 Release No. 34-42728, 33-7856, IC-24426,

Web site has certainly become a ubiquitous and advantageous medium for communicating with current and potential shareholders, as well as propagating market information and fiscal results.⁴ One of the most important benefits of this new electronic media is that company information can be broadcast to both investors and the world financial markets swiftly in a cost-reducing and widespread manner.⁵

The increased use of the Internet by corporate securities issuers as a mode of general information distribution has led to concern about the application of the federal securities laws to these transmissions.⁶ Indeed, as the utilization of the Internet by securities investors grows exponentially,⁷ and conventional causes of action are applied to the use of this new communications medium,⁸ securities

[2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,304, at 83,375 (May 17, 2000). [hereinafter SEC Release No. 34-42728] The SEC Release No. 34-42728 is intended to provide further guidance on the application of federal securities laws to electronic media. *Id.* The Release was aimed at issuers desirous of utilizing the electronic media to transmit corporate information. *Id.*

⁴ Lisa Klein Wager, *Safe Harbors in Cyberspace*, N.Y. L.J., August 20, 1998 at 3, (col. 1) (discussing compliance review procedures for posting information on corporate web sites).

⁵ S.E.C. Release No. 34-42728, *supra* note 3, at 83,375-376.

⁶ SEC Approves Issuance of Interpretive Release on the Use of Electronic Media, S.E.C. 00-53, 2000 WL 491108, *1 (S.E.C.) (Apr. 26, 2000) (describing highlights of the interpretations of federal securities laws provided by the SEC in Release No. 34-42728, including electronic delivery of documents, permissible web site content, online offerings, and technology concepts); *see also* Jane Kaufman Winn, *Regulating the Use of the Internet Securities Markets*, 54 BUS. LAW. 443, 445 (1998) (discussing issues not yet addressed by the SEC under federal securities laws and their application to the Internet).

⁷ The first Internet-based securities trading systems were introduced in 1995. U.S. Securities and Exchange Commission, *Office of Compliance Inspections and Examinations: Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations*, available at <http://www.sec.gov/news/studies/online.htm> (last modified Jan. 25, 2001) (reporting SEC findings pursuant to examinations of registered broker-dealers conducted between October 1998 and January 2001 by the SEC Office of Compliance Inspections and Examinations, National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE)). Since 1995, online investing has expanded dramatically—according to a recent estimate, there are 7.8 million persons trading online, executing 807,000 trades per day. *Id.* at 2. As of January 25, 2001, there were at least 200 broker-dealers offering retail investors with the ability to trade online. *Id.*

⁸ The origins of the Internet are traceable to the ARPANET (acronym for Advanced Research Projects Agency Network), a network linked together in 1969 between four computers located at The University of California, Los Angeles campus, The University of California, Santa Barbara campus, Stanford University, and The University of Utah. Barry M. Leiner, et al., *A Brief History of the Internet*, at <http://www.isoc.org/internet/history/brief#Origins> (last visited November 27, 2001). The original ARPANET grew into the Internet, which, by 1996, included

issuers face possible liability under a variety of theories for information contained on their Internet sites or otherwise disseminated by them.⁹ There is no doubt that the new Web technology poses more serious disclosure-related risks to securities issuers than ever before.¹⁰ Companies must therefore be wary because they may run afoul of federal securities regulation despite having the best intentions.¹¹

This paper will survey the precepts and the landscape of the federal securities laws, particularly as applied to an issuer's potential liability in relation to the statements or misstatements present in the reports of third-party analysts. This area of issuer liability for the content of third-party analyst reports has been litigated somewhat extensively in the field of issuer-distribution of paper-based analysts' reports,¹² but such litigation is nonexistent where distribution is of

50,000 operational networks on all seven continents and in outer space, with 29,000 such networks in the United States alone. *Id.* Since 1996, the number of registered domain names on the Internet has increased from 240,000 to 1.4 million, and the number of Internet sites has jumped from 100,000 to over 28 million. Robert Hobbes' Zakon, *Hobbes' Internet Timeline v5.3*, at <http://www.zakon.org/robert/internet/timeline/> (last updated April 15, 2001) (providing tabular statistics on the growth of the Internet).

⁹ Gregory A. Markel & Nancy I. Ruskin, *Internet Litigation and How to Avoid It*, N.Y. L.J., May 24, 1999 at S5 (col. 1) (discussing possible areas of liability for information included on company web sites and otherwise disseminated through company e-mail, including areas such as defamation, securities fraud, and misuse of nonpublic personal information).

¹⁰ Robert A. Prentice, Vernon J. Richardson & Susan Scholz, *Corporate Web Site Disclosure and Rule 10b-5: An Empirical Evaluation*, 36 AM. BUS. L.J. 531, 542 (1999) (discussing potential for, and possible strategies to avoid, liability under Section 10(b) and Rule 10b-5 of the federal securities laws for material misstatements or omissions regarding information included on issuer Web sites).

¹¹ Blake A. Bell, *Corporate Web Sites and Securities Offerings*, N.Y. L.J., May 21, 1998 at S5 (col. 1) (cautioning issuers to understand the risks attendant with establishing an Internet presence).

¹² Such litigation arises more frequently out of district courts located in the Ninth Circuit due in no small part to the explosive growth in the 1980s and 1990s of technology corporations in California's Silicon Valley. *See Eisenstadt v. Allen*, 113 F.3d 1240, No. 95-16255, 1997 WL 211313 (9th Cir. Apr. 28, 1997); *In re DSP Group, Inc. Sec. Litig.*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,525 (N.D. Cal. Mar. 5, 1997); *Strassman v. Fresh Choice Inc.*, No. C-95-20017 RPA, 1995 WL 743728 (N.D. Cal. Dec. 7, 1995); *Fisher v. Acuson Corp.*, No. C 93-20477 RMW (EAI), 1995 WL 261439 (N.D. Cal. Apr. 26, 1995); *Stack v. Lobo*, 903 F. Supp. 1361 (N.D. Cal. 1995); *In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369 (N.D. Cal. 1995); *In re Seagate Technology II Sec. Litig.*, 1995 Fed. Sec. L. Rep. (CCH) ¶ 98,530 (N.D. Cal. Feb. 8, 1995); *In re Software Pub. Sec. Litig.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,094 (N.D. Cal. Feb. 2, 1994); *In re Caere Corporate Sec. Litig.*, 837 F. Supp. 1054 (N.D. Cal. 1993); *In re RasterOps Corp. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,790 (N.D. Cal. Aug. 13, 1993); *In re Syntex Corp. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,747

the hyperlink variety. This paper will explore litigated cases and discuss how the analysis therein may be applied to hyperlinks to analysts' reports contained on an issuer's Internet Web site.

The central question is whether the jurisprudence attendant to issuer-distribution of paper-based analysts' reports is applicable to hyperlinked distribution of analysts' reports, or whether there is some other liability scheme that would prove more appropriate. In applying such jurisprudence to Web-based dispersion of analysts' reports, securities issuers must unfortunately be extremely hesitant and thoughtful before they choose to embed a link to an analyst report on their Internet sites.

I. THE INTERNET

The Internet is one of the most productive and powerful modern-day tools.¹³ It is essentially a limitless collection of interconnected computers, all with the ability to communicate with each other, and linked together on one large-scale computer network.¹⁴ The technology behind the Internet works as follows: individual computers are connected to a local Internet Service Provider, or ISP, which in turn connects to a regional ISP, and ultimately to the World ISP, or Internet.¹⁵ Therefore, every computer on the Internet is connected with every other computer on the Internet.¹⁶ The Internet

(N.D. Cal. Sept. 1, 1993); *In re Verifone Sec. Litig.*, 784 F. Supp. 1471 (N.D. Cal. 1992); *In re Quarterdeck Office Systems, Inc. Sec. Litig.*, Blue Sky L. Rep. (CCH) ¶ 73,835, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,646 (C.D. Cal. Nov. 4, 1992); *Alfus v. Pyramid Technology Corp.*, 764 F. Supp. 598 (N.D. Cal. 1991).

¹³ It is currently estimated that there are 391 million individuals using the Internet worldwide, 170 million in the United States alone, and that number is expected to increase to 770 million worldwide by 2003. Global Reach, *Global Internet Statistics (by Language)*, at <http://www.glreach.com/globstats/index.php3> (last modified Mar. 31, 2001); *Details of country/language analysis*, available at <http://www.glreach.com/globstats/details.html> (last modified Mar. 31, 2001). Just under 19 million domain names were registered in 2000, representing a 285% increase in registration of domain names over the previous year. NetFactual.com, *Domain Name Growth Analysis*, at <http://www.netfactual.com/PDF/DomainYearlyGrowthStudy2.pdf> (last visited Apr. 7, 2001). As of July 3, 2000, of the over 5 million active Internet Web sites, 16% of them, or about 930,000, had the capability of performing E-commerce transactions. Netfactual.com, *The E-Commerce Universe*, at <http://www.netfactual.com/PDF/Ecomm-Universe.pdf> (last visited Apr. 7, 2001).

¹⁴ Marshall Brain's HowStuffWorks, *How Web Servers and the Internet Work*, available at <http://www.howstuffworks.com/web-server1.htm> (last visited Feb. 24, 2001).

¹⁵ See *id.* (for diagram). Home computers are connected to their local ISPs via telephone, digital subscriber, or cable modem line. Computers located at businesses or universities are connected to a Local Area Network (LAN) within the organization that is connected through a T1 line to their local ISP. See *id.*

¹⁶ *Id.*

thus grants access to a wide accumulation of documents contained on various "web pages" which can each be linked together in a spider-web like structure via a "hyperlink."¹⁷

A. *Hyperlinks*

Widely utilized on Internet Web sites is the hyperlink, a device that enables a viewer of one Internet Web page to click instantly from the screen in front of them to another document or Internet Web site.¹⁸ The hyperlink is really an electronic path, usually displayed in the form of highlighted text, button, or graphics, that affiliates one Web page with another and enables viewers to immediately connect to the linked Web page by directing their mouse to the text, button, or graphics.¹⁹ Hyperlinks allow Web site operators to advertise and afford access to other Internet sites, thus enabling users to find information, products, and services throughout the Internet with very little effort or expense.²⁰

"Framing"²¹ involves the use of a hyperlink to establish a link from one page to another, and in addition also allows the features of the first page to remain on the viewer's screen while simultaneously generating a framed window inside which the hyperlinked page appears.²² Several of these framed windows may be displayed at one time, but the viewer never actually leaves the original site in which the hyperlinks are embedded.²³ Another form of hyperlinking,

¹⁷ Eileen Smith Ewing, *Fraud On The Cybermarket: Liability For Hyperlinked Misinformation Under Rule 10b-5*, 56 BUS. LAW. 375, 377 (2000) (discussing the application of anti-fraud provisions of the federal securities laws, particularly Section 10(b) and Rule 10b-5, as well as recent SEC interpretive releases, to the use of hyperlinks to third party analyst information on issuer Web sites).

¹⁸ Netdictionary, at <http://www.netdictionary.com/html/h.html> (last visited Apr. 7, 2001); see also Denis T. Rice, *The Regulatory Response to the New World of Cybersecurities*, 51 ADMIN. L. REV. 901, 901 (1999) (analyzing the landscape of current and potential federal securities regulation to the burgeoning Internet-based securities marketplace).

¹⁹ S.E.C. Release No. 34-42728, *supra* note 3, at 83,376 n.7.

²⁰ Scott M. Pearson & James J. Thompson, *Can Hyperlinks Trigger Broker-Dealer Registration Requirements? A Survey of SEC No-Action Letters*, WALLSTREETLAWYER.COM: SECURITIES IN THE ELECTRONIC AGE, August 1999 at 14 (surveying SEC No-Action Letters on the subject of the inclusion of hyperlinks on an issuer Web site as triggering registration and other requirements under the Exchange Act of 1934).

²¹ "Framing" allows the simultaneous loading of two or more separately scrollable windows, within which the user can view different Web sites. Webguest Web Glossary, at <http://www.webguest.com/glossf.html> (last visited Apr. 7, 2001); Netdictionary, at <http://www.netdictionary.com/html/f.html> (last visited Apr. 7, 2001).

²² Joseph P. Zammit & Felicia Gross, *Web Site Liability: Risks and Cost of Compliance*, 611 PRAC. L. INST. 815, 868 (2000) (discussing how a "framed" link works).

²³ *Id.*

known as "inlining,"²⁴ is similar to framing but does not result in a visible border, though both the original site and the hyperlinked site are simultaneously accessible by the viewer.²⁵ Under both "framing" and "inlining," the viewer may be unaware that the newly displayed material is actually from a separate Web site.²⁶

From a securities issuer standpoint, there is a danger that the hyperlinking process may be held to affiliate imprecise or fraudulent content from the linked Internet site in a way that contradicts federal securities laws.²⁷ Indeed, the simple act of embedding a hyperlink in a company's Web site, ostensibly for purposes of promoting more efficient and less costly access to vital financial analyst information, may be enough to entangle the issuer with the information embodied at the opposite end of the hyperlink.²⁸

II. FEDERAL SECURITIES LAWS

The supreme governing regulatory scheme in the area of securities law is the Securities Act of 1933²⁹ (hereinafter the '33 Act) and the Securities and Exchange Act of 1934³⁰ (hereinafter the '34 Act). These Securities Acts, passed in the wake of the 1929 stock market crash, were enacted to ensure that companies wishing to issue public securities complied with certain disclosure obligations, thus guaranteeing that the public markets were equipped with all critical valuation information.³¹ The '33 Act was promulgated to deal with the initial distribution of securities.³² The '34 Act was designed to address post-issuance trading of securities.³³ The Acts embody both the economic reforms advocated by President Franklin Delano

²⁴ "Inlining" is similar to "framing" but does not result in a visible border surrounding the imported Web site. S.E.C. Release No. 34-42728, *supra* note 3, at 83,382 n.60.

²⁵ *Id.*

²⁶ *Id.* at nn.59, 60 (differentiating between "framing" and "inlining").

²⁷ Bell, *supra* note 11.

²⁸ David L. Mathus & Andrew M. Goldner, *Precautions Can Mitigate Legal Dangers of Web Sites - Privacy Concerns, Hyperlink Liability and Jurisdiction Issues Should All be Contemplated*, NAT'L L.J. June 21, 1999 at C3 (col. 1) (employing SEC analysis of "entanglement liability" to forewarn that the use of hyperlinks to third-party analyst information may induce liability *per se*).

²⁹ Codified at 15 U.S.C.A. § 77a-7aa (2000).

³⁰ Codified at 15 U.S.C.A. § 78a-78mm (2000).

³¹ D. Joseph Meister, *Securities Issuer Liability for Third Party Misstatements: Refining the Entanglement Standard*, 53 VAND. L. REV. 947, 955-56 (2000) (generally discussing the federal regulatory framework in the United States).

³² LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 34 (3d ed. 1995).

³³ *Id.*

Roosevelt in his 1932 presidential campaign,³⁴ and the view that sunlight should be cast upon the securities markets, in the form of disclosure obligations, to ensure that instability would become less prevalent in the capital markets.³⁵

The '33 Act requires certain disclosures pursuant to registration with the SEC of qualifying securities intended to be publicly traded.³⁶

³⁴ The New York Times on the Web, *The Times Looks Back: Presidential Elections 1886-1996*, at <http://www.nytimes.com/learning/general/specials/elections/1932/> (last visited Apr. 7, 2001). During the 1932 Presidential campaign, candidate Franklin Delano Roosevelt called for reform measures to revive the dire economic climate, but remained vague about specific programs he would implement. *Id.* After his election, Roosevelt officially gave life to the New Deal economic recovery program. *Id.*

³⁵ LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 2-3 (3d ed. 1998).

³⁶ The primary disclosure requirements of the '33 Act involve the preparation of a registration statement and prospectus by issuers of securities intended to be offered to the public. Rice, *supra* note 18 at 904. Unless exempted by Section 3 or Section 4 of the '33 Act, Section 5 of the '33 Act mandates that an issuer must prepare a registration statement and prospectus to be filed with the SEC prior to issuance for the purpose of providing public disclosure. See 15 U.S.C.A. § 77c & 77d (listing the securities expressly covered by the Act, and those securities and transactions specifically exempted therefrom); 15 U.S.C.A. § 77e (1999). Section 5 of the '33 Act further prohibits the sale or delivery of securities until the required registration statement becomes effective. 15 U.S.C.A. § 77e(a) (1999). Once the registration statement is filed pursuant to Section 5, a waiting period ensues wherein sales of the effected security are barred until the statement becomes effective, but efforts to sell the security, such as "tombstone" advertisements, may commence. Satu S. Svahn, *Greater Investor Outreach At The Click Of A Mouse: Internet and Closed-Circuit Roadshows Should Reach Retail Investors*, 65 BROOK. L. REV. 249, 257-58 (1999); see also Henrique de Azevedo Ferreira Franca, *Legal Aspects of Internet Securities Transactions*, 5 B.U. J. SCI. & TECH. L. 4, ¶ 17-19 (1999). After the registration statement is filed and even when it becomes effective, any written offer based upon that registration statement must be in connection with a prospectus in compliance with Section 10 of the '33 Act. 15 U.S.C.A. § 77e (2000). Upon consummation of any sale of a security pursuant to a registration statement, a final prospectus must accompany the delivery of the security to the investor. *Id.* Section 7 of the '33 Act sets forth the information required to be included in the registration statement and further grants broad authority to the SEC over the contents of the registration statement. 15 U.S.C.A. § 77g (1999). Section 7 stipulates that the registration statement of a non-foreign issuer must contain disclosure as listed in Schedule A of the '33 Act and grants authority to the SEC over whether to enlarge or restrict the required disclosures in a given situation. Schedule A lists 32 itemized disclosures, including but not limited to such items as the name the issuer will do business as; the State of incorporation of the issuer; the location of the issuer's principal place of business; names and addresses of the issuer's directors, CEO, underwriters, and 10% shareholders, and the amount of securities held by such persons; the character and type of business to be transacted by the issuer; statement of the capitalization of the issuer, including the authorized and outstanding number of shares; purpose of issuance and use of funds raised therefrom; estimated net proceeds of the issuance; remuneration paid or expected to be paid to the issuer's directors during the past and ensuing year; names and addresses of counsel who reviewed the legality of the issuance and a copy of their opinion as to such legality; profit and loss statement of the issuer; balance sheet of

Securities issuers also have an affirmative duty under federal securities laws to disclose to the public markets any material, non-public information when situations arise that would be reasonably likely to have a material effect on the issuer's financial condition.³⁷ In this respect, the federal securities laws are aimed at investor protection.³⁸

The information required to be disclosed in a registration statement pursuant to Section 7 of the '33 Act can generally be separated into four categories: (1) information regarding the issuer; (2) information regarding the distribution and use of the proceeds of the issuance; (3) a description of the issuer's securities; and (4) various exhibits and undertakings required to be filed as part of the registration statement.³⁹ The information within the first three categories must be reproduced in the prospectus pursuant to Section 10 of the '33 Act.⁴⁰ Once registered with the SEC, Section 12 of the '34 Act⁴¹ requires certain continuous disclosures with the SEC.⁴²

In order to promote effective disclosure under the federal securities laws, an issuer is encouraged to furnish information, but is prohibited, among other things, from employing any fraudulent device, scheme, or artifice; making any false statement of material fact, or failing to state a material fact needed to make the statements,

the issuer; dates of and parties to certain material contract made by the issuer, and the articles of incorporation of the issuer. See 15 U.S.C.A. § 77aa (1999) for a complete list. Section 10 of the '33 Act details the information required to be disclosed in the prospectus and grants equally broad interpretive power to the SEC. 15 U.S.C.A. § 77j (1999). Section 10 stipulates that the information required to be disclosed in the prospectus shall contain the same information required to be included in the registration statement, as denoted in Schedule A of the '33 Act. *Supra* note 21. However, Section 10 specifically excludes items 28 through 32 of Schedule A. See 15 U.S.C.A. § 77(j).

³⁷ Meister, *supra* note 31, at 956 (discussing mandatory disclosure requirements implemented by the '33 and '34 Acts).

³⁸ Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 280 (2000) (arguing that the regulatory approach undertaken by the federal government is ill-advised and that the focus of such regulation, in order to maximize investor protection, should be investors rather than issuers).

³⁹ JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 240-41 (2d ed. 1997); 15 U.S.C.A. § 77j (1999).

⁴⁰ *Id.*

⁴¹ See 15 U.S.C.A. § 78m (1999).

⁴² In particular, a registered issuer must file an annual Form 10-K within 90 days after the issuer's fiscal year-end, a quarterly Form 10-Q within 45 days after the end of the first three fiscal quarters, and a Form 8-K within either 15 days or 5 days, depending on the circumstances, of the occurrence of a significant event. Herbert S. Wander, *Postgraduate Course in Federal Securities Law: Developments in Securities Law Disclosure*, SF05 A.L.I.-A.B.A. 441, 453 (1999).

in light of the background under which such statements were made, not misleading.⁴³ Indeed, the text of Section 10(b) of the '34 Act⁴⁴ is comprehensive, prohibiting "any person . . . in connection with the purchase or sale of any security" from utilizing or employing "any manipulative or deceptive device or contrivance in contravention of" SEC rules.⁴⁵ Rule 10b-5,⁴⁶ promulgated by the SEC under Section 10(b) of the '34 Act, and worded equally broadly, renders it unlawful:

(a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁴⁷

To prevail on a claim under Rule 10b-5, one must prove the existence of: (1) a false statement or omission of a material fact; (2) reliance on such statement or omission; (3) scienter; and (4) damages.⁴⁸ Indeed, it is under Section 10(b) and Rule 10b-5 of the federal securities laws where issuers have been assailed for their affinity for using third-party analysts' reports.⁴⁹

Pursuant to the inherent difficulty in determining when an issuer has violated the boundless matrix of disclosure requirements under the federal securities laws, both the courts and the SEC have fashioned peripheral rules of disclosure, including those discussed below.

⁴³ Robert M. Sobol, *Internet Complicates Securities Law—The World Wide Web Can Trip the Unwary Company*, LEGAL INTELLIGENCER, November 29, 1999 at 7 (examining liability under federal securities regime for misstatements and omissions on an issuer's Web site).

⁴⁴ Codified at 15 U.S.C.A. § 78j(b) (1999).

⁴⁵ Ralph C. Ferrara, Donna M. Nagy, Herbert Thomas & Thomas J. Kim, FERRARA ON INSIDER TRADING & THE WALL, § 7.05 (2000) (citing 15 U.S.C. § 78j(b) (1994)) (discussing possible corporate compliance programs to deter Section 10(b) and Rule 10b-5 liability for insider trading and faulty disclosure).

⁴⁶ Codified at SEC Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2001).

⁴⁷ SEC Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2001).

⁴⁸ *In re Oak Technology Sec. Litig.*, No. 96-10552, 1997 U.S. Dist. Lexis 18503, *7, *11 (N.D. Cal. Aug. 1, 1997) (holding that plaintiff failed to adequately plead a Rule 10b-5 claim by neglecting to explain how and why defendant's alleged misstatements were in fact false).

⁴⁹ See *infra* note 112 (discussing litigation applying the entanglement standard).

A. Forward-Looking Information

The SEC initially scorned the use of filings containing forward-looking,⁵⁰ or “soft,” information in SEC filings due to its inherent mistrust of the reliability of such information, and based on intrinsic uncertainty of the information and the issuer’s motivations in propagating overly optimistic or distorted information.⁵¹ Essentially outlawed under the federal securities regulatory scheme until the 1970s,⁵² the use of forward-looking disclosure has gradually become not only permissible, but also encouraged.⁵³ This encouragement

⁵⁰ Forward-looking information is generally referred to in terms of “soft” information, or that which describes events or activities that will occur at some future date. SECURITIES REGULATION: CASES AND MATERIALS, SECOND ED., *supra* note 39, at 71. It is also a term of art, defined under the auspices of “forward-looking” information at 17 C.F.R. 230.175(c) (2001). Dale Arthur Oesterle, *The Inexorable March Toward A Continuous Disclosure Requirement For Publicly Traded Corporations: “Are We There Yet?”*, 20 CARDOZO L. REV. 135, 149 n.65 (1998). 17 C.F.R. 230.175(c) states:

For the purpose of this rule, the term “forward-looking statement” shall mean and shall be limited to: (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items; (2) A statement of management’s plans and objectives for future operations; (3) A statement of future economic performance contained in management’s discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K (§ 229.303 of this chapter) or Item 5 of Form 20-F; or (4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c)(1), (2), or (3) of this section.

17 C.F.R. 230.175(c) (2001).

⁵¹ Victor Brudney, *A Note On Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 753 (1989) (discussing the history of, and rationale behind, the SEC’s hostility towards projections, asset appraisals, and other future-oriented information).

⁵² Bruce A. Hiler, *The SEC and the Courts’ Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1120-22 (1987). From its inception, the SEC felt that investors should be given only “objectively verifiable facts from which they in turn could extrapolate any relevant forward-looking information.” *Id.* at 1117-18. The SEC stated in a 1973 Release that “[i]t has been the Commission’s long-standing policy generally not to permit projections to be included in prospectuses and reports filed with the Commission.” *Id.* at n.7 (quoting Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,666 (Feb. 2, 1973)). It was not until 1972 that the SEC formally took up the issue of allowing soft or predictive information in filings. *Id.* at 1120. By 1978, the SEC had issued a statement authorizing the use of forward-looking information both in SEC filings and in general. *Id.* at 1122 (citing Guides for Disclosure of Projections for Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978)).

⁵³ Wander, *supra* note 42, at 489 (explaining that the importance of forward-

began in the late 1970s, when criticism over the contradictory SEC position on the use of soft information in SEC filings⁵⁴ manifested itself with the promulgation of Rule 175 under the '33 Act⁵⁵, and Rule 3b-6⁵⁶ under the '34 Act.⁵⁷ These rules adopted a safe harbor provision preventing liability under the federal securities laws for forward-looking information "unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."⁵⁸ Even with this statutory safe harbor, such "soft" information in the form of projections and other generic optimistic statements are rarely included in SEC filings or public disclosures due to the onslaught of securities claims that have challenged even the slightest misstated predictions.⁵⁹

B. "Bespeaks Caution" Doctrine

The Court of Appeals for the Third Circuit, in *In re Donald Trump Casino Securities Litigation*,⁶⁰ held that specifically detailed and meaningful cautionary language can serve to render omissions and misstatements contained in a prospectus immaterial as a matter of law.⁶¹ Boilerplate cautionary language, however, will not garner such

looking information to private issuances compelled the SEC to allow its inclusion in SEC filings and generally).

⁵⁴ The argument being that the underlying purpose of the federal securities disclosure obligations was to promote inclusion of all relevant information in the market whereas the SEC position restricting the inclusion of such forward-looking information was deleterious to that aim. See Schulte, *infra* note 57.

⁵⁵ Codified at 17 C.F.R. § 230.175 (2001).

⁵⁶ Codified at 17 C.F.R. § 240.3b-6 (2001).

⁵⁷ Stephen J. Schulte, *Corporate Public Disclosure: Primer for the Practitioner*, 15 CARDOZO L. REV. 971, 973-74 (1994) (discussing SEC long-standing view that predictive information should not be allowed due the likelihood that investors would attach undue weight to such information).

⁵⁸ *Id.* (quoting 17 C.F.R. §§ 230.175(a), 240.3b-6(a) (1993)).

⁵⁹ Wander, *supra* note 42 at 489 (discussing litigation arising under Rule 175).

⁶⁰ 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). In *In re Donald Trump Casino*, the prospectus for bonds issued to fund the construction of the Taj Mahal Casino in Atlantic City, NJ contained the statement: "[t]he partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal)." *Id.* at 365. Of course, such funds were not sufficient and when the investors sued, the Third Circuit found for the issuers based upon the inclusion of an immediately accompanying cautionary statement in a "Special Considerations" section of the prospectus that: "[n]o assurances can be given, however, that the actual operating results will meet the Partnership's expectations." *Id.* at 370-71. This "Special Considerations" section of the prospectus contained several detailed and carefully worded cautionary statements concerning the investment. *Id.* at 370.

⁶¹ *Id.* at 371. See also Richard Y. Roberts, *The Constantly Evolving Nature of Federal Securities Law: An Introduction to the Symposium*, 45 ALA. L. REV. 729, 744 (1994); *In re*

protection, and would not suffice to protect the speaker from running afoul of the federal securities law disclosure requirements.⁶² Thus, under the “bespeaks caution” doctrine, as espoused in *Trump*, courts will refuse to attach liability under the federal securities laws to those issuing statements “tempered by warnings of risk” even where such statements prove to be incorrect.⁶³ This common law doctrine has had the effect of plugging up holes in the SEC and statutory safe harbor provisions for forward-looking and other statements subject to federal securities laws.⁶⁴ Under the doctrine, speakers of otherwise vulnerable statements, or those who fail to correct a previously issued statement, may escape liability through the inclusion of a carefully worded cautionary statement.⁶⁵

C. Duty to Update

The First Circuit in *Backman v. Polaroid*,⁶⁶ announced that if a disclosure made by an issuer is in fact misleading when it was made, and the speaker thereafter learns of the misleading nature of the

International Business Machines Corp. Sec. Litig., 163 F.3d 102, 107 (2d Cir. 1998) (holding that a public denial of intent to cut dividends followed by appropriate cautionary language was protected by the Bespeaks Caution doctrine); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991) (holding that an issuer’s optimistic statements regarding an analyst’s estimates were not materially misleading where the statement bespoke caution). *But see* *Fecht v. The Price Company*, 70 F.3d 1078, 1082 (9th Cir. 1995) (casting further doubt on the Bespeaks Caution doctrine in finding that dismissals of securities claims under the doctrine will be carefully reviewed); *Rubenstein v. Collins*, 20 F.3d 160, 167 (5th Cir. 1994) (stating that “cautionary language is not necessarily sufficient, in and of itself, to render predictive statements immaterial as a matter of law”); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414-15 (9th Cir. 1994) (holding that the Bespeaks Caution doctrine applies only to statements of future projections, estimates or forecasts in a prospectus); *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir. 1993) (finding that cautionary statements cannot as a matter of law render statements of opinion, pursuant to *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), unactionable under the federal securities laws).

⁶² *In re Donald Trump Casino*, 7 F.3d at 371-72. *See also* Donald C. Langevoort, *The Epistemology Of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 653 (1997) (citing *In re Donald Trump Casino*, 7 F.3d 357 (3d Cir. 1993)).

⁶³ D. Brian Hufford, *Deterring Fraud vs. Avoiding the “Strike Suit”: Reaching an Appropriate Balance*, 61 BROOK. L. REV. 593, 607-08 (1995).

⁶⁴ Jonathan B. Lurvey, *Who Is Bespeaking To Whom? Plaintiff Sophistication, Market Information, and Forward-Looking Statements*, 45 DUKE L.J. 579, 580 (1995) (discussing the contradictory historical SEC view on the use of forward-looking information and the protection afforded to speakers by the Third Circuit in *In re Donald Trump Casino*).

⁶⁵ *Id.* at 580-82 (discussing the “Bespeaks Caution” doctrine).

⁶⁶ 910 F.2d 10 (1st Cir. 1990) (en banc).

statement, there is a duty to update it.⁶⁷ Though the dissent in *Backman* decried a general "duty to update,"⁶⁸ as other courts have flatly rejected,⁶⁹ the doctrine remains active as applied to information which becomes materially false for as long as such information remains "alive" and influences the investment decision of the reasonable investor.⁷⁰

D. 1995 Private Securities Litigation Reform Act (PSLRA) and 1998 Securities Litigation Uniform Standards Act (SLUSA)

A groundswell movement against the proliferation of federal securities claims, particularly for misstatements in predictive information, led to the passage in 1995 of the Private Securities Litigation Reforms Act.⁷¹ One of the more heralded components of

⁶⁷ *Id.* at 16-17.

⁶⁸ *Id.* at 21 (Bownes, J. dissenting) ("Upon reconsideration, I am persuaded that certain language in the panel opinion, when construed in the factual context of this case, could be interpreted as creating an overly broad duty on the part of corporations to update even accurate statements of past historical fact"). The duty to update is not to be confused with the duty to correct, which attaches "when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by *subsequently discovered* information actually was not." *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1431 (3d Cir. 1997) (citing *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331-32 (7th Cir. 1995)).

⁶⁹ *See Stransky*, 51 F.3d at 1332 (refusing to adopt a *per se* duty to update forward-looking information, stating that "[t]his court has never embraced such a theory, and we decline to do so now"). *See also Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir. 1997) (affirming *Stransky* precedent that no duty to update exists in the Seventh Circuit).

⁷⁰ *Meister*, *supra* note 31, at 962-63; *Weiner v. Quaker Oats*, 129 F.3d 310, 318 (3d Cir. 1997) (holding that Quaker had a duty to update its statements regarding its debt-to-total capitalization when they became unreliable). *Id.* at 318. *See also In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) (holding that "when a corporation is pursuing a specific business goal and announces that goal as well as intended approach for reaching it, it may come under an obligation [*e.g.* duty to update] to disclose other approaches to reaching the goal when those approaches are under active and serious consideration") (author's note added).

⁷¹ In June and July of 1993, the Senate Subcommittee on Securities began hearings on private securities litigation reform. P.L. 104-67, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, S. REP. NO. 98, 104TH CONG., 1ST SESS. 1995, 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (Leg. Hist.) (June 19, 1995). Substantial testimony was given regarding the proliferation of frivolous "strike" suits by plaintiff's lawyers, against issuers who disclose bad news or whose stock experiences a sharp decline, alleging violations of the federal securities laws in the hope that defendant issuers will quickly settle to avoid litigation expenses. *Id.* As Senate Subcommittee Chairman Alfonse D'Amato (R-NY) expressed at a hearing on reform proposals on March 2, 1995:

There is broad agreement on the need for reform. Shareholders' groups, Corporate America, the SEC, and even lawyers all want to curb abusive practices. Lawyers who bring meritorious suits do not benefit

the PSLRA is the protection for forward-looking statements, which is intended to provide extra protection for overly optimistic information.⁷² In addition to this protection, those statements made without actual knowledge of falsity are also protected.⁷³ There has been some confusion over the pleading standard under the PSLRA,⁷⁴

when strike suit artists wreak havoc on the Nation's boardrooms and courthouses. Our economy does not benefit when the threat of litigation deters capital formation.

Id. As stated in the Joint House and Senate Conference Report on the Private Securities Litigation Reform Act of 1995:

The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

P.L. 104-67, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, H.R. CONF. REP. NO. 369, 104TH CONG., 1ST SESS. 1995, 1995 U.S.C.C.A.N. 730, 1995 WL 709276 (Leg. Hist.) (Nov. 28, 1995). The PSLRA of 1995 was vetoed by President Clinton, but Congress subsequently overrode the President's veto. John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 Bus. Law. 335, 335 (1996) (discussing the legislative struggle between Congress and President Clinton over passage of the PSLRA). The PSLRA is codified at 15 U.S.C.A. § 77z-1 (West 2001).

⁷² Richard A. Rosen, *The Statutory Safe Harbor For Forward-Looking Statements In The Courts: A Year 2000 Scorecard*, 1213 PRAC. L. INST. 765, 769 (2000).

⁷³ *Id.* at 780.

⁷⁴ Mark H. Gitenstein & Charles A. Rothfeld, *Securities Litigation Reform-Early Signs of Success*, 7 No. 1 ANDREWS DERIVATIVES LITIG. REP. 11 (2001) (discussing ambiguity among courts, based upon legislative history of the PSLRA, as to the adequate pleading standard thereunder). Gitenstein & Rothfeld state:

The perhaps inevitable result of this ambiguity has been a continuing conflict among the federal courts of appeals about both the proper pleading standard under the PSLRA and the nature of the scienter that must be established to make out a case of securities fraud. The courts have now adopted three general approaches. 1. The Second Circuit, understandably enough, has taken the position that Congress meant to endorse that court's pre-PSLRA approach. Citing its pre-statute decisions, the Second Circuit's first post-PSLRA holding reaffirmed that, under the PSLRA, "a plaintiff must either (a) allege facts to show that 'defendants had both motive and opportunity to commit fraud' or (b) allege facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness.'" *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (quoting *Shields v. Citytrust Bancorp Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994)) . . . 2. The Ninth

but the general consensus is that issuers will have greater protection for forward-looking statements under the PSLRA.⁷⁵ The confusion over the interpretation of the PSLRA led to the passage in 1998 of the Securities Litigation Uniform Standards Act, or SLUSA, which served to restrict the venue choice to the federal courts for most securities class action suits.⁷⁶

Circuit has taken the opposite tack, endorsing both a pleading and a scienter standard that is much stricter than those in the Second Circuit. In *In re Silicon Graphics Securities Litigation*, 183 F.3d 970 (9th Cir. 1999), a divided panel of the Ninth Circuit, without reference to the PSLRA, elevated the required scienter standard in securities fraud suits. Rather than "normal" recklessness—that is, indifference on the defendant's part to the likely consequences of its actions—the court concluded that "recklessness only satisfies scienter [requirements] under Section 10(b) to the extent that it reflects some degree of intentional or conscious misconduct." *Id.* at 977 (emphasis added). . . . 3. Finally, the First, Sixth and 11th Circuits have taken a middle ground between the more liberal Second and the more conservative Ninth Circuit approaches. These courts have, however, differed somewhat among themselves on the nuances of their tests.

Id.

⁷⁵ See Rosen, *supra* note 72, at 785 ("A scorecard, in this context, is a relatively primitive device for trying to figure out whether plaintiffs or defendants are currently "ahead." But to continue the metaphor for a moment, we're still in only the second inning or so, and the umpires in the Courts of Appeals and the Supreme Court have yet to call any close plays").

⁷⁶ Wander, *supra* note 42, at 524-25 (discussing the history of the passage of the SLUSA in an attempt to provide a more precise interpretation of the PSLRA). As stated by President Clinton:

Since passage of the [Private Securities Litigation] Reform Act, there has been considerable concern that the goals of the Reform Act have not been realized. In particular, there was testimony that firms are not using the Federal safe harbor for forward-looking statements because they fear State court litigation over the same representations that are protected under Federal law. In addition, concerns have been raised that State actions are being used to achieve an "end-run" around the Reform Act's stay of discovery. In signing the Uniform Standards Act, I do so with the understanding, as reflected in the Statement of Managers for this legislation and numerous judicial decisions under the Reform Act adopting the pleading standard of the Second Circuit, that investors with legitimate complaints meeting the Second Circuit pleading standard will have access to our Nation's courts. This point was critical to my veto of the Reform Act in 1995; it was reaffirmed before ultimate passage of the 1995 Act over my veto; and its assurance was a prerequisite to my signing this legislation today

STATEMENT BY PRESIDENT WILLIAM J. CLINTON UPON SIGNING S. 1260, P.L. 105-353, SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998, 1998 WL 972001 (Leg. Hist.) (Nov. 3, 1998). The SLUSA makes federal court the exclusive venue for most securities class action claims, the purpose being to deter plaintiffs from seeking to evade protections offered by federal law, particularly by the PSLRA of 1995, against abusive litigation by filing frivolous "strike" claims in state court, rather than federal court. SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998, HOUSE CONFERENCE

III. ROLE OF ANALYSTS

The danger involved when an issuer deals with analysts has been described as “a fencing match conducted on a tightrope.”⁷⁷ However, analysts and analysts’ reports are generally utilized by investors, who must sort through an endless amount of investment data in order to acquire insight into a company’s management, finances, business and, most significantly, prospects for future success.⁷⁸

There is wide acceptance of the view that securities analysts play a meaningful role in contributing to efficient markets by digesting and integrating massive amounts of information, sifting through the “noise,” and producing an abridged report portraying a securities-issuer’s future prospects.⁷⁹ Indeed, a prevailing theory of corporate valuation lauds the value of information, including analysts’ reports, as vital to the valuation of a company in the public market.⁸⁰ This prevalent modern theory of corporate valuation, known as the “efficient market theory,” posits that the key to an efficient, and therefore fair, capital market is the availability to the public market of all information about a given company necessary to accurately value or price that company in the public market.⁸¹ The theory holds that absent a sound valuation, the danger of over or under-valuation will permeate the public markets and create hazardous economic conditions for unwary investors.⁸² At its core, the efficient market

REPORT NO. 105-803, H.R. CONF. REP. NO. 803, 105TH CONG., 2ND SESS. 1998, 1998 WL 703964 (Leg. Hist.) (Oct. 9, 1998).

⁷⁷ Richard E. Gutman, *Preparation of Annual Disclosure Documents 2000: Dealing With Analysts*, 1161 611 PRAC. L. INST. 11, 13 (2000) (quoting *S.E.C. v. Bausch & Lomb*, 565 F.2d 8, 9 (2d Cir. 1977)).

⁷⁸ John F. Olson, Ronald O. Mueller, Gavin A. Beske, *The Perils of Presstek: The SEC Addresses Entanglement and Adoption of Analysts’ Reports*, INSIGHTS, March 1998 at 2 (discussing the peril involved in the interaction between management and third-party analysts).

⁷⁹ Laura Simone Unger, *Corporate Communications Without Violations*, 51 ADMIN. L. REV. 1119, 1122 (1999).

⁸⁰ See Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851 (1992) (quoting Judge Easterbrook’s view in *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 510 (7th Cir. 1989), that “the Securities and Exchange Commission believes that markets correctly value the securities of well-followed firms, so that new sales may rely on information that has been digested and expressed in the security’s price”).

⁸¹ See VICTOR BRUDNEY & WILLIAM W. BRAXTON, BRUDNEY & CHIRELSTEIN’S CORPORATE FINANCE 120-136 (4th ed. 1993). The efficient market theory has been propagated in three forms including the ‘weak’ form, the ‘semi-strong’ form, and the ‘strong’ form. *Id.* at 126.

⁸² Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 773-76 (1995) (discussing the lack of adequate information available in the marketplace as leading to over or under-investment).

theory says that, at any given time, all information existing in the public domain concerning a company is reflected in the price of the stock of that company.⁸³

Corporate management therefore is caught in a conundrum of whether to follow their instincts in providing access to third-party economic information, or restricting such access in compliance with the federal securities laws. Once issued, analysts' reports may be viewed by corporate management, as well as by investors, as a trusted endorsement of management's business strategy from a knowledgeable and independent third party.⁸⁴

Embedding hyperlinks to third-party analysts' reports on a company's Web site, therefore, may be seen by corporate management as an inexpensive way to guide investors towards useful investment advice. However, the federal securities laws, as applied to hyperlinked information on corporate Web sites, may have no greater manifestation of potential liability from an issuer-perspective than where hyperlinks to third-party analysts' reports are concerned.⁸⁵

A. Dirks

The United States Supreme Court, in *Dirks v. SEC*,⁸⁶ stated that analysts' work is "necessary to the preservation of a healthy market."⁸⁷ Though Raymond Dirks could not have known it at the time, his animosity toward the SEC, and theirs toward him, played a vital role

⁸³ Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 763 (1985) (examining the underpinnings and fallacies of the efficient market hypothesis).

⁸⁴ Olson, Mueller & Beske, *supra* note 78, at 2 (analyzing the need for accurate information to be provided to investors in order that they make a sound investment decision).

⁸⁵ Norman B. Antin & Jeffrey D. Haas, *Maintaining a Web Site and Avoiding Liability Under the Securities Laws*, 117 BANKING L.J. 519, 529 (2000) (arguing that the potential for liability may be great for hyperlinked information on corporate Web sites because though companies have long-standing internal policies for reviewing release of written communications, no such internal policies exist for content of corporate Web sites, including hyperlinked third-party analyst reports); Martin G. Byrne & Alice A. Pellegrino, *Hyperlinks Under the Federal Securities Laws*, WALLSTREETLAWYER.COM: SECURITIES IN THE ELECTRONIC AGE, October 2000 at 7 (warning of pockets of uncertain liability under the federal securities laws for hyperlinking to third-party information).

⁸⁶ 463 U.S. 646 (1983).

⁸⁷ *Id.* at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."); Gutman, *supra* note 77, at 13 (discussing the sometimes precarious, but often mutually beneficial relationship between analysts and securities issuers).

in the evolution of the view of analyst involvement with corporate issuers.⁸⁸ The *Dirks* case involved the attempted censure by the SEC of Raymond Dirks, an analyst for a broker-dealer, for insider trading violations under Rule 10b-5.⁸⁹ Dirks had alerted his clients to sell out of Equity Funding of America upon his discovery from a former Equity Funding employee that the company was falsifying financial statements.⁹⁰ The Supreme Court found that holding Dirks liable under Rule 10b-5 solely because he was in receipt of material inside information from an insider would frustrate the role of market analysts, a role recognized by the SEC itself as useful to the market in “ferret[ing] out and analyz[ing] information.”⁹¹ In fact, much to the dismay of the SEC, the Court lauded Dirks for exposing a massive fraud to the public, one that, but for his involvement, may have gone undetected.⁹²

Ever since the *Dirks* decision, the SEC has lobbied for greater regulation of the relationship between analyst and issuer in the form of the prohibition of selective disclosure.⁹³

⁸⁸ The tenuous relationship between Raymond Dirks and the SEC was recounted in a seminar presented by Paul Gonson. Paul Gonson, Remarks at the Prudential Insurance Company of America’s Newark Headquarters (Nov. 9, 2000). Mr. Gonson worked at the SEC for twenty years and argued the case against Raymond Dirks for the SEC. *Id.* A partner with the Washington D.C. office of Kirkpatrick & Lockhart LLP at the time of this writing, Mr. Gonson recounted the animosity surrounding the attempted prosecution of Raymond Dirks by the SEC. *Id.* He noted that although the SEC was generally in favor of analysts who use their expertise and due diligence to obtain vital valuation information about an issuer, there was general disfavor for those analysts who come across information merely by coincidence or as the result of being “passive recipients” of insider information, as was the case with Raymond Dirks. *Id.*

⁸⁹ Codified at SEC Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2001). The SEC position was that Dirks, in repeating insider allegations of fraud to members of the investment community who subsequently sold their stock in Equity Funding, was guilty of aiding and abetting a Section 10(b) and Rule 10b-5 violation. *Dirks*, 463 U.S. at 650-51.

⁹⁰ *Id.* at 649-50.

⁹¹ *Id.* at 658. (quoting 21 S.E.C. Docket 1401, 1406 (1981)).

⁹² *Id.* at 659. The Court stated:

Despite the unusualness of Dirks’ “find,” the central role that he played in uncovering the fraud at Equity Funding, and that analysts in general can play in revealing information that corporations may have reason to withhold from the public, is an important one. Dirks’ careful investigation brought to light a massive fraud at the corporation. And until the Equity Funding fraud was exposed, the information in the trading market was grossly inaccurate. But for Dirks’ efforts, the fraud might well have gone undetected longer.

Id.

⁹³ J. Scott Colesanti, *Bouncing the Tighrope: The S.E.C. Attacks Selective Disclosure, But Provides Little Stability for Analysts*, 25 S. ILL. U. L.J. 1, 1-2 (2000) (discussing recent

B. *Regulation FD (Fair Disclosure)*

Regulation FD,⁹⁴ effective November 2000, focuses primarily on the relationship between issuers and securities analysts.⁹⁵ Regulation FD prohibits selective disclosure by securities issuers by providing that when an issuer discloses material nonpublic information to analysts and other securities market professionals, it must also make public disclosure of such information.⁹⁶ If the initial disclosure to an analyst

attempts by the SEC to "declare war" on selective disclosure between analysts and issuers); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1034-36 (1990) (discussing SEC attempts post-*Dirks* to lobby Congress to enact stricter disclosure rules regarding analyst-issuer communications).

⁹⁴ Codified at 17 C.F.R. §§ 243.100-103 (2001). Regulation FD stands for the proposition that if analysts are privy to, and trade on, inside information knowing the information to be such, it is just as wrong as if it were done by a corporate insider. As then SEC Chairman Arthur Levitt descriptively stated, regarding the SEC view toward analyst involvement, "[t]he behind-the-scenes feeding of material non-public information from companies to analysts is a stain on our markets." Wander, *supra* note 42, at 584 (citing Rachel Witmer, Levitt Lambasts Analysts, Firms for "Gamesmanship," Selective Disclosure, SEC REG. & L. REP. Vol. 31, No. 41 at 1390 (Oct. 1999) (quoting a speech given by Arthur Levitt on October 18, 1999 to the Economic Club of New York)).

⁹⁵ U.S. Securities and Exchange Commission, *Speech by SEC Commissioner: Fallout from Regulation FD Has the SEC Finally Cut the Tightrope?*, at <http://www.sec.gov/news/speech/spch421.htm> (last modified Nov. 13, 2000). In the speech, SEC Commissioner Laura S. Unger expressed her dissent from the adoption of Regulation FD, stating that:

I dissented from the adoption of Regulation FD for several reasons. First, I thought the rule was unnecessary . . . Second, I was concerned that the rule would result in issuers' scaling back their disclosure, rather than expanding it. On one hand, companies might restrict communications because of a fear of violating Regulation FD. On the other hand, companies that did not wish to talk to analysts could use Regulation FD as cover. At a time when the Internet is making more information available, it just didn't make sense to adopt a rule that would most likely reduce the amount of information available to investors. Third, I was concerned about the quality of the information that would be produced in response to Regulation FD. Considering the number of press releases that could be issued for intentional or inadvertent disclosures of material, nonpublic information, the webcasting of analyst calls – and the instantaneous nature of these communications – I was concerned that investors would not be able to process the information.

Id.

⁹⁶ Selective Disclosure and Insider Trading, S.E.C. Release No. 33-7881, 34-43154, IC-24599 (S.E.C.), Selective Disclosure and Insider Trading, File No. S7-31-99 RIN 3235-AH82 (Oct. 23, 2000); *available at* <http://www.sec.gov/rules/final/33-7881.htm> (last visited Feb. 24, 2001). Regulation FD provides that:

Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information . . . (1)

was intentional, Regulation FD mandates that public disclosure be made simultaneously, and, if the initial disclosure was unintentional, mandatory public disclosure must be made promptly, or "as soon as reasonably practicable."⁹⁷ Regulation FD also intends to prevent the use of material information to curry favor with particular analysts, as well as from excluding analysts who author negative reports about the issuer.⁹⁸ However, Regulation FD is only applicable if an issuer provides material nonpublic information to an analyst, or other listed person, where it is "reasonably foreseeable" that the recipient will trade the stock of the issuer on the basis of the information disclosed.⁹⁹

The SEC's position is thus that insider trading is just as harmful if done by an analyst as if done by a corporate insider.

C. *Entanglement Theory*: *Elkind v. Liggett & Myers*¹⁰⁰

The entanglement theory of liability arises in connection with an issuer's involvement with the preparation of third-party analyst reports.¹⁰¹ This theory creates two distinct problems: (1) liability for the content of the analyst report, including the analyst's independent projections, even where the issuer refuses to comment on portions of the report; and (2) a duty to update and/or correct information presented in such report.¹⁰²

The Court of Appeals for the Second Circuit, in *Elkind v. Liggett*

Simultaneously, in the case of an intentional disclosure; and (2)

Promptly, in the case of a non-intentional disclosure.

17 C.F.R. § 243.100(a) (2001).

⁹⁷ 17 C.F.R. § 243.101 (d) (2001); Linda C. Quinn, *Learning To Live With Regulation FD - Shearman & Sterling Client Publication*, 1212 PRAC. L. INST. 9, 12 (2000).

⁹⁸ Caroline B. Blitzer, *Recent Developments: From ADR to Taxation*, 48 LA. B.J. 309, 311 (2000).

⁹⁹ Selective Disclosure and Insider Trading, S.E.C. Release No. 33-7881, *supra* note 96; Harvey L. Pitt, Karl A. Groskaufmanis, Jonathan P. Scott & Daniel H. Anixt, *The Internet Age: What Securities Lawyers Need to Know To Survive - The SEC's Selective Disclosure Rule*, 1211 PRAC. L. INST. 279, 281 (2000) (analyzing the recently adopted Regulation FD). Regulation FD states: "this section shall apply to a disclosure made to any person outside the issuer . . . [w]ho is a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information." 17 C.F.R. § 243.100(b)(1)(iv) (2001).

¹⁰⁰ 635 F.2d 156 (2d Cir. 1980).

¹⁰¹ *Id.* at 163.

¹⁰² See Steven E. Bochner & Ignacio E. Salceda, *Over the Wall: Handling Securities Analysts' Conference Calls, Earnings, Forecasts, and Reports Effectively*, 1149 PLI/Corp 131, 136-37 (2000) (discussing adoption versus entanglement theories of liability for material misstatements or omissions contained in third-party analysts' reports).

& Myers Inc., confronted the then-novel issue of issuer liability for third party misstatements in analyst reports. In *Elkind*, a shareholder of Liggett & Myers instituted a class action claiming that information provided by the issuer to third party analysts, who were preparing reports analyzing the issuer, violated federal securities laws.¹⁰³ Liggett & Myers, confronted with the sagging price of its stock, implemented a corporate program designed to promote closer relations between itself and its analysts in order to promote the resurgence of the price of its stock.¹⁰⁴ In addition, Liggett reviewed and commented on the reports of analysts involved with the program prior to their publication, providing corrections to perceived errors and other misunderstandings.¹⁰⁵ Ultimately, Liggett cultivated favorable reports from the analysts and failed to provide their less optimistic internal projections.¹⁰⁶

The Second Circuit held that Liggett had not “sufficiently entangled itself” with the analysts so as to render predictions made in such reports attributable to Liggett itself.¹⁰⁷ The court explained that Liggett had not placed its “imprimatur, expressly or impliedly, on the analysts’ projections.”¹⁰⁸ Though Liggett was relieved from liability for its association with the analysts, the court expounded on the dangerous nature of such relationships, particularly of the pre-release review of analyst reports.¹⁰⁹ Thus, under *Elkind*, if an issuer does

¹⁰³ *Elkind*, 635 F.2d at 158-59.

¹⁰⁴ *Id.* at 159.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 162.

¹⁰⁷ *Id.* at 163.

¹⁰⁸ *Id.* The court added:

The company did examine and comment on a number of reports, but its policy was to refrain from comment on earnings forecasts. Testimony at trial indicated that the analysts knew they were not being made privy to the company’s internal projections. While the evidence leaves little doubt that Liggett made suggestions as to factual and descriptive matters in a number of the reports it reviewed, the record does not compel the conclusion that this conduct carried a suggestion that the analysts’ projections were consistent with Liggett’s internal estimates. Nor has plaintiff demonstrated that Liggett left uncorrected any factual statements which it knew or believed to be erroneous. Thus, Liggett assumed no duty to disclose its own forecasts or to warn the analysts (and the public) that their optimistic view was not shared by the company.

Id.

¹⁰⁹ *Elkind*, 635 F.2d at 163-64, stating that:

While we find no liability for non-disclosure in this aspect of the present case, it bears noting that corporate pre-release review of the reports of analysts is a risky activity, fraught with danger. Management

“sufficiently entangle” itself with the preparation of an analyst report, liability under the federal securities laws may attach for failure to correct, or update, third-party analyst reports that, in light of current circumstances, may be materially misleading or false.¹¹⁰

Cases subsequent to *Elkind* have applied the entanglement theory to disparate circumstances and to variable levels of issuer involvement with the cultivation of analyst reports.¹¹¹ The difficulty

must navigate carefully between the “Scylla” of misleading stockholders and the public by implied approval of reviewed analyses and the “Charybdis” of tipping material inside information by correcting statements which it knows to be erroneous. A company which undertakes to correct errors in reports presented to it for review may find itself forced to choose between raising no objection to a statement which, because it is contradicted by internal information, may be misleading and making that information public at a time when corporate interests would best be served by confidentiality. Management thus risks sacrificing a measure of its autonomy by engaging in this type of program. Since Liggett had not undertaken to pass on earnings forecasts, however, it did not violate any duty to correct these figures.

Id.

¹¹⁰ *Id.* at 163. The court stated:

We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views.

Id.

¹¹¹ Ewing, *supra* note 17, at 385. In *Alfus v. Pyramid Technology Corp.*, a plaintiff class of shareholders claimed that the defendant issuer was liable for misleading forecasts in an analyst report because the issuer provided the information upon which the report was based. 764 F. Supp. 598, 603 (N.D. Cal. 1991). The district court, relying upon the *Elkind* entanglement theory, denied defendant's motion to dismiss the plaintiff's complaint. *Id.* The court found that there was a sufficient claim for the trier of fact to determine whether the information provided to the analyst did in fact constitute the forecast information at issue. *Id.*

In *SEC v. Wellshire Securities, Inc.*, an appeal from an SEC enforcement action against an analyst who solicited correction from an issuer of a drafted report, the court refused to find sufficient entanglement under *Elkind* because the level of involvement was less than that of the issuer in *Elkind*. 773 F. Supp. 569, 573 (S.D.N.Y. 1991). In *Wellshire*, an analyst that authored a newsletter solicited the issuer to review comments made in a draft of the newsletter about a recent acquisition of the issuer. *Id.* at 572. The issuer's insiders, including their counsel, reviewed the draft and sent it back to the analyst. *Id.* After review of the draft, the issuer became aware that its recent acquisition was not as financially secure as it had previously thought, due to misrepresentations made by the principals of the acquired company. *Id.* at 574. The acquisition was subsequently rescinded, and the issuer's financial statements were amended to reflect the change. *Id.* The court stated, in discussing the issuer's actions:

That the . . . defendants actively sought to confirm the information by

encountered under the *Elkind* entanglement standard is the inconsistency with which courts conclude that interaction between an issuer and analyst rise to the level of "entanglement." Increasingly, courts strictly construe the entanglement standard, requiring plaintiffs to plead specific facts definitively linking an analyst's

consulting with knowledgeable individuals, passing along corrections to [the analyst], indicates no more than a willingness to be cooperative. If I were to find that to constitute "entanglement" in furtherance of a fraud, I fear as a consequence a pervasive chilling effect on cooperation and honesty, especially in light of the fact that personal reputations and livelihoods are often that which are at stake.

Id.

In an unpublished opinion by the Fourth Circuit Court of Appeals, *Herman v. Legent Corp.*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,650 (4th Cir. Mar. 20, 1995), the court refused to find entanglement where, similar to the facts in *Elkind*, the issuer made optimistic guidance statements to analysts but reserved more morose internal projections from the analyst's eyes. *Id.* at 92,002-003. When the truth came out and the shareholders sued, the court found for the issuer in that the statements of the analyst contained in the report were not attributable to the issuer, either literally or via the *Elkind* entanglement theory. *Id.* at 92,010. The court stated:

We find no evidence that Legent sufficiently entangled itself with Smith's report to make his statements attributable to the company, or that it "place[d] its imprimatur, expressly or impliedly," on Smith's report. Smith's visit to Legent was unlike the conference calls, in which Legent released information to analysts in order to promote "much more concise and precise [street] estimates and guidance." Indeed, the fact that Legent used conference calls to ensure that all of the market analysts heard the same information at the same time works against any inference that we should attribute Smith's report to Legent. The Smith report did not directly quote Legent's management or reveal who supplied the information to Smith. There is no evidence that Legent had any control over the contents of the report, or, even if Legent had such control, that the report was so inconsistent with Legent's internal estimates that it would require Legent to correct the statements in the report.

Id. (citations omitted).

In *In re ICN/Viratek Sec. Litig.*, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,213 (S.D.N.Y. Apr. 9, 1996), shareholders sued for material misstatements in an analyst report where the analyst was given access to material nonpublic information during a due diligence review pursuant to its prior underwriting of the issuer's securities, and a final draft of the subsequent analyst report was reviewed and corrected by insiders at the issuer. *Id.* at 95,083-084. The court found sufficient entanglement under *Elkind* to allow liability on the part of the issuer for material misstatements contained in the analyst report. *Id.* at 95,086. The court stated:

[We] accordingly hold that, under *Elkind*, a reasonable factfinder could conclude from the evidence submitted that defendants so entangled themselves with the initial Paine Webber report, by their review and amendment of the final draft of the report just before its issuance, that the report's statements could properly be attributed to them.

Id.

statement in a report to individual insiders at an issuer.¹¹²

D. Adoption Theory: Raab v. General Physics

One of the problems with the *Elkind* entanglement theory is that

¹¹² Wander, *supra* note 42, at 587. See also *Eisenstadt v. Allen*, 113 F.3d 1240, No. 95-16255, 1997 WL 211313, at *15 (9th Cir. Apr. 28, 1997) (holding that no triable issue exists where plaintiffs showed only issuer interaction with analysts but failed to put forth any evidence that issuer reviewed any of the analyst reports after the analyst had drafted them); *In re Cypress Semiconductor Securities Litigation*, 891 F. Supp. 1369, 1377 (N.D. Cal. 1995) (holding that circumstantial evidence of conversations between issuer and analyst during the class action period is insufficient to plead entanglement where no further evidence of issuer comment on the report was put forth); *Greenberg v. Compuware Corp.*, 889 F. Supp. 1012, 1021 (E.D. Mich. 1995) (stating that allegations that an issuer provided "guidance" to analysts and discussed "relevant aspects of the Company's operations and financial prospects . . . in order to cause or encourage them to issue favorable reports" did not alone amount to an allegation of an actionable entanglement); *In re Caere Corporate Sec. Litig.*, 837 F.Supp. 1054, 1058 (N.D. Cal. 1993) (strictly construing the entanglement standard to deny plaintiff's assertion that a vague statement made by an issuer regarding an analyst report sufficiently entangled the issuer therewith). In *In re Caere*, the issuer's CFO stated, in response to an analyst's forecasts, "that 'the first quarter is typically slower, reflecting seasonality in Caere's business,' and that 'as a result, results for the [first] quarter are always difficult to predict.'" *Id.* at 1060. The court observed that "[i]t strains the intellect to imagine how this statement could constitute entanglement." *Id.* See also *In re DSP Group, Inc. Sec. Litig.*, [1997 Transfer Binder] Fed. Sec. L. Rep. ¶ 99,525, at 97,562 (N.D. Cal. Mar. 5, 1997) (dismissing plaintiff's entanglement claim where non-specific allegations were proffered that analysts provided draft reports to insiders for review); *In re Seagate Technology II Sec. Litig.*, 1995 Fed. Sec. L. Rep. ¶ 98,530, at 91,583 (N.D. Cal. Feb. 8, 1995) (holding that evidence that analysts sent drafts of their reports to the issuer, without more, is insufficient to show entanglement where no evidence is shown that the issuer acted upon the reports prior to publication); *In re Quarterdeck Office Systems, Inc. Sec. Litig.*, 854 F. Supp. 1466, 1473 (C.D. Cal. 1994) (finding for defendant issuer where plaintiff raised allegations only that statements contained in an analyst's report were based upon information provided by the issuer, but offered no proof that the issuer placed its imprimatur on the analyst report); *Colby v. Hologic, Inc.*, 817 F. Supp. 204, 215 (D. Mass. 1993) (holding that vague and non-specific "gossamer allegations" of misleading guidance given by an issuer to an analyst are insufficient to plead entanglement where no evidence is proffered that actual individual defendants led analysts astray); *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1486-87 (N.D. Cal. 1992) (dismissing plaintiff's entanglement claim where plaintiff showed merely that the issuer was in possession of projections which contradicted those contained in an analyst's report where the issuer had no affirmative knowledge that the projections in the report were unreasonable). But see *J/H Real Estate Inc. v. Abramson*, 901 F. Supp. 952, 958 (E.D. Pa. 1995) (holding that plaintiffs met entanglement standard, thus defendant had a duty to update, by tying material misrepresentations in the analyst report to statements made by specified individuals at the issuer); *In re RasterOps Corp. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. ¶ 97,790, at 97,849 (N.D. Cal. Aug. 13, 1993) (finding that all plaintiff has to do to plead entanglement is allege that defendant issuer provided information to the analyst upon which the reports at issue were based, where plaintiff pleads specific such allegations).

analysts may be provided with information by an issuer sufficient to rise to the level of entanglement, but may, in turn, distort or misrepresent the information without granting the issuer an opportunity to review such changes.¹¹³ An enhanced version of entanglement theory, the "adoption theory" of liability, emphasizes issuer control over information transmitted to the markets in final form.¹¹⁴

The Court of Appeals for the Fourth Circuit addressed this issue in *Raab v. General Physics Corp.*¹¹⁵ *Raab* involved an analyst report that contained a statement indicating that the pace of contract awards had recently increased significantly.¹¹⁶ When earnings proved to be less than expected for the following two quarters, the shareholders sued.¹¹⁷ The court, applying the entanglement theory, found that the plaintiffs failed to adequately plead specific allegations from which it could be implied that the issuer exercised sufficient control over the report that would render the issuer liable for statements made therein.¹¹⁸

¹¹³ Ewing, *supra* note 17, at 386.

¹¹⁴ Adoption theory emphasizes the notion that an issuer, through its own conduct, may adopt third-party analysts' reports as its "own by implicitly representing that the information contained therein was accurate or reflected the views of the company," without having anything to do with the preparation thereof. Robert Norman Sobol, *The Tangled Web of Issuer Liability for Analyst Statements: In Re Cirrus Logic Securities Litigation*, 22 DEL. J. CORP. L. 1051, 1065 (1997) (distinguishing adoption from entanglement theory).

¹¹⁵ 4 F.3d 286 (4th Cir. 1993).

¹¹⁶ *Id.* at 287. The statement was not identified by source and was contained in a six-page buy recommendation issued by Goldman Sachs one year after issuance of the issuer's stock. *Id.* The report stated that:

Fourth-quarter results were adversely impacted by a slowdown in the procurement of new contracts by the Department of Energy (DOE). The decision last fall to reduce U.S. nuclear weapons has Congress and the DOE reevaluating the nuclear weapons complex. As a result, the procurement of some contracts has been delayed. *General Physics has indicated that the pace of contract awards has increased significantly in recent weeks.*

Id.

¹¹⁷ *Id.* at 288.

¹¹⁸ *Id.* 288-89. The court stated:

The securities laws require General Physics to speak truthfully to investors; they do not require the company to police statements made by third parties for inaccuracies, even if the third party attributes the statement to General Physics. Without control over Goldman Sachs' report, any statement made by General Physics personnel could be taken out of context, incorrectly quoted, or stripped of important qualifiers. Plaintiffs have thus failed to plead facts from which it could be inferred that General Physics exercised the kind of control over the Goldman Sachs report that would render it liable for statements made

This "control" element of entanglement jurisprudence, as amplified by subsequent decisions,¹¹⁹ has elevated the *Elkind* test to an adoption standard. The adoption standard requires a showing of a "two-way flow of information" from an analyst to an insider at the issuer, and also an "adoption" of the contents of the report.¹²⁰ In

therein.

Id.

¹¹⁹ See *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1466 (N.D. Cal. 1996) (finding that defendant corporation had failed to "adopt" third-party analysts' statements regarding the defendant's business, where no evidence was proffered that defendant had any express or implicit control over such statements). The court stated:

There is no guarantee that the statements are transcribed accurately, nor that the reported statements include any material qualifications provided by the company necessary to make the reported statements not misleading. It is plainly unfair to hold defendants liable for the reporting of their statements by third parties without independent corroboration of the accuracy of the reported statements.

Id. at 1469. See also *Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1126 (W.D. Mich. 1996) (holding that "none of the statements made by the market analysts or newspaper accounts were pled with the requisite particularity to implicate defendants because none of the allegations indicates how defendants either controlled the content of the articles or knew that the articles would transmit defendants' statements without first being edited"); *Herman v. Legent Corp.*, [1995] Fed. Sec. L. Rep. (CCH) ¶ 98,650, (4th Cir. Mar. 20, 1995), 50 F.3d 6, 92,010 (Table) C.A.4 (Va. 1995), (stating that "we find no evidence from which a reasonable jury could infer that Legent had sufficient control over Smith's report to hold it liable for the statements made therein"); *Strassman v. Fresh Choice, Inc.*, No. C-95-20017 RPA, 1995 WL 743728, *9 (N.D. Cal. 1995) (holding that "[i]f the defendants have no control over the third party account, any statement made by them could be 'taken out of context, incorrectly quoted, or stripped of important qualifiers.' Here, Plaintiffs fail to plead with proper specificity how the Corporate Defendants controlled the content of the news articles" (quoting *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 965 (D. Md. 1995))).

¹²⁰ *Ewing*, *supra* note 17, at 386; *Meister*, *supra* note 31, at 968-69. See *In re Syntex Corp. Sec. Litig.*, 95 F.3d 922 (9th Cir. 1996). The *In re Syntex* court stated:

Here, Defendants never endorsed or adopted the statements of analysts; they never put their "imprimatur on the projections." Instead, these statements were the culmination of a one-way flow of information, from Syntex representatives to analysts and from the analysts to their customers. In fact, when Defendant Freiman (Syntex's CEO) was asked about the analysts' predictions related to future earnings per share, Freiman stated, "We don't forecast earnings," and emphasized that such estimates should not be attributed to Syntex. Thus, Syntex did not adopt or entangle itself in the analysts' statements.

Id. at 934.

See also *In re Burlington Coat Factory*, 114 F.3d 1410, 1429 (3d Cir. 1997). In *In Re Burlington*, the Third Circuit averred that an enthusiastic expression by a corporate insider during a securities analysts' conference that he was "comfortable" with analysts' earnings estimates would constitute an adoption thereof. The court stated:

To say that one is "comfortable" with an analyst's projection is to say

essence, the adoption standard is the entanglement standard dressed up in a heightened pleading requirement.¹²¹ The adoption theory for misstatements in third-party analyst reports attaches to pre-publication or post-publication endorsement of a report by an issuer, but would presumably not attach where an issuer has had no meaningful pre-publication preparatory interaction with the analyst who drafted the report.¹²²

E. *Post-Publication Ratification Theory: In re RasterOps Corp., In re Cypress Semiconductor and In the Matter of Presstek, Inc.*

*In re RasterOps Corp. Securities Litigation*¹²³ marked the beginning of the "post-publication ratification theory" of liability for third-party analysts' reports.¹²⁴ In that case, the court found that circulation of an analyst report by an issuer is sufficient to deem the issuer to have "placed its imprimatur" on the analyst report.¹²⁵

that one adopts and endorses it as reasonable. When a high-ranking corporate officer explicitly expresses agreement with an outside forecast, that is close, if not the same, to the officer's making the forecast. We see no reason why adopting an analyst's forecast by reference should insulate an officer from liability where making the same forecast would not.

Id. at 1429; *Schaffer v. Timberland Co.*, 924 F. Supp. 1298 (D.N.H. 1996). *Schaffer* requires a three-part showing by a plaintiff to aver defendant issuer's adoption of the analyst report: "(1) identify specific forecasts and name the [defendant] insider who adopted them; (2) point to specific interactions between the insider and the analyst which gave rise to the entanglement; and (3) state the dates on which the acts which allegedly gave rise to entanglement occurred." *Id.* at 1310 (citations omitted).

¹²¹ Under *Elkind* entanglement jurisprudence, plaintiffs claiming an improper relationship between analyst and issuer sufficient to trigger liability for misstatements and omissions contained in such report needed only to plead that the issuer had "sufficiently entangled" itself with the preparation of the report. *See Elkind v. Liggett & Myers Inc.*, 635 F.2d 156, 162 (2d Cir. 1980). Under *Raab* adoption analysis, however, courts have required plaintiffs to plead with particularity specific actions of the defendant issuer signifying their explicit or implicit control over the statement of the third-party analyst. *See supra* note 119.

¹²² Ewing, *supra* note 17, at 387.

¹²³ [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,467 (N.D. Cal. 1994).

¹²⁴ Under entanglement theory, liability rests on whether the third-party analysts' statements may be imputed to the company based upon pre-publication interaction between analyst and issuer, whereas under the post-publication ratification theory, liability depends on the company's implied representation that the third-party analysts' forecasts contained in a published report are accurate. Jack Karns, *Independent Financial Analyst's Reports and the "Post-Publication Ratification Theory": Is a Company Liable for Voluntary Circulation of a Favorable Report?*, 32 NEW ENG. L. REV. 1023, 1034 (1998).

¹²⁵ *In re RasterOps*, 1994-1995 Fed. Sec. L. Rep. at 91,195. The court stated: Accordingly, the allegation that RasterOps circulated the analyst

The post-publication ratification theory of liability was advanced in *In re Cypress Semiconductor Securities Litigation*.¹²⁶ In this case, the court explored the liability of issuers who had little or no involvement with analysts in the preparation of an analyst report, but who subsequently distributed or performed some other affirmative action post-publication.¹²⁷ The court ultimately held that the defendant issuer was not liable for material misstatements in third-party analysts' reports because the plaintiff failed to show that the issuer reviewed such reports prior to their issuance, or that the issuer represented that the reports were accurate.¹²⁸

Applying the ratification theory, the SEC in *In the Matter of Presstek, Inc.*,¹²⁹ instituted an enforcement action against an issuer where senior management at the issuer reviewed, edited, and distributed an analyst's report that grossly overstated the issuer's financial outlook.¹³⁰ The SEC found that in distributing the report containing materially false projections for six to seven months, to hundreds of investors, and without the use of a disclaimer, Presstek had adopted the contents of the report.¹³¹ The Commission, holding

reports to potential buyers of its stock, coupled with allegations that the company provided false information to the analysts and approved drafts of the reports, is sufficient to establish that Rasterops "placed its imprimatur on the projections, thereby adopting them as their own."

Id., (quoting *In re Quarterdeck Office Systems, Inc. Sec. Litig.*, 854 F. Supp. 1466, 1473 (C.D. Cal.1994).

¹²⁶ 891 F. Supp. 1369 (N.D. Cal. 1995).

¹²⁷ *Id.* at 1377. The court stated:

In addition to engaging in pre-publication entanglement activity, a corporation may ratify analysts' reports after they have been published. This occurs when a company conveys the suggestion that the analysts' forecasts are accurate or at least in accordance with its views. Distributing analysts' reports to potential investors may, depending on the circumstances, amount to an implied representation that the reports are accurate. In such a case, in contrast to pre-publication entanglement, liability does not depend upon imputing the analysts' statements to the company. Rather, the corporation's implied representation that the analysts' forecasts are accurate is itself actionable. This is a subtle, yet important distinction between pre-publication adoption and post-publication ratification.

Id. (citations omitted).

¹²⁸ *Id.*

¹²⁹ Exchange Act Release No. 34-39472, 1997 WL 784548 (Dec. 22, 1997).

¹³⁰ *Id.* at *1.

¹³¹ *Id.* at *2. The SEC stated "Although the PMG Report included some cautionary language expressing the author's uncertainty as to whether Presstek would achieve the projected results, Presstek distributed the report without any disclaimer, thus placing the company's imprimatur on the report and undercutting the reservations included in the report." *Id.* at *7.

Presstek liable for the contents of the report, espoused the post-publication ratification theory of liability in order to lessen confusion arising from prior judicial decisions concerning adoption versus entanglement liability.¹³²

The Commission's opinion in *Presstek* was formulated to expressly carve out the post-publication ratification theory in the hope that distinctions between it and the pre-publication adoption theory would be further settled by subsequent court decisions.¹³³

IV. SEC RELEASES

A. October 1995 Release

In an interpretive release promulgated in October 1995, the SEC emphasized that the liability provisions contained in the federal securities laws apply evenly to electronic and non-electronic media.¹³⁴ The SEC concurrently accepted that the use of electronic media modernized the efficiency of the securities markets and provided a more efficient way to disseminate information.¹³⁵ In particular, the October 1995 Release authorized the use of electronic media to

¹³² *Id.* at *10. The SEC stated:

The Commission is mindful that certain judicial decisions addressing liability for third party misstatements do not clearly distinguish between pre-publication entanglement and post-publication adoption theories of liability, and that some decisions suggest that an issuer's pre-publication involvement with a third-party report is necessary to hold the issuer liable for misstatements made in the report.

Id.

In the Commission's view, under certain circumstances an issuer that disseminates false third party reports may adopt the contents of those reports and be fully liable for the misstatements contained in them, even if it had no role whatsoever in the preparation of the report. If an issuer knows, or is reckless in not knowing, that the information it distributes is false or misleading, it cannot be insulated from liability because management was not actively involved in the preparation of that information.

Id.

The SEC added that through the "distribution of the analyst report, Presstek adopted the report's misleading projections, and is liable under the post-publication adoption theory." *Id.* at *11.

¹³³ Karns, *supra* note 124, at 1039.

¹³⁴ Markel & Ruskin, *supra* note 9 (citing Use of Electronic Media for Delivery Purposes, Release No. 33-7233; 34-36345, 1995 SEC Lexis 2662, 60 Fed. Reg. 54,458, 53,459 n.10 (Oct. 6, 1995)).

¹³⁵ Kimberly Banks MacKay & Michael J. Holliday, *Company Web Sites: Guidelines For Avoiding Securities Law Liability*, NEW JERSEY LAWYER, December 2000 at 10 (Dec. 2000), citing Use of Electronic Media for Delivery Purposes, SEC Release No. 33-7233, *infra*.

disseminate filing information. Thus, issuer or third party information deliverable in paper form under the federal securities laws could also be delivered electronically.¹³⁶

In approving the use of electronic delivery of documents in the October 1995 Release, the SEC also endorsed the "electronic envelope theory." This theory implies that any material posted on an issuer's Web site, whether in standard or "HTML text,"¹³⁷ or hyperlinked form, is imputed to the issuer.¹³⁸ This theory held the potential for grave issuer liability for all information contained on Web sites connected to an issuer's site by a hyperlink.¹³⁹

B. May 2000 Release

To ameliorate issuer fears pertaining to embedding hyperlinks to third-party analysts' reports, the SEC issued a Release, effective May 5, 2000:

[to] [r]educe uncertainty regarding permissible web site content to encourage more widespread information dissemination to all investors by clarifying . . . some of the facts and circumstances that may result in an issuer having adopted information on a third-party web site to which the issuer has established a hyperlink for purposes of the anti-fraud provisions of the federal securities laws¹⁴⁰

The May 2000 Release averred that the attribution of hyperlinked data contained on a third-party Web site to an issuer whose site embeds a hyperlink thereto depends on the facts and

¹³⁶ Use of Electronic Media for Delivery Purposes, S.E.C. Release No. 33-7233; Exchange Act Release No. 34-36345 (Oct. 6, 1995), *available at* <http://www.sec.gov/rules/concept/33-7233.txt> (last visited Aug. 13, 2000).

¹³⁷ "HTML" stands for hypertext markup language, which describes text that includes links to other documents. Netdictionary, *at* <http://www.netdictionary.com/html/h.html> (last visited Apr. 8, 2001).

¹³⁸ Daniel D. Rubino, Paul J. Shim, Carol R. Leslie & Laura L. Delanoy, *Corporate and Securities Law Update*, 67 PRAC. L. INST. 11, 39 (1999). The "envelope theory" espoused in the October 1995 Release was aimed at imputing material misstatements or omissions contained in documents either included on an issuer's site or at the other end of a hyperlink embedded on an issuer's site to the issuer. *Id.* The theory when applied to hyperlinks provides that when a hyperlink is inserted onto an issuer's site, it provides direct access to another site thus assimilating the content of the two sites into one electronic document. *Id.*; Linda C. Quinn & Otilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*, SF05 A.L.I.-A.B.A. 641, 672 (2000). Thus the content of both sites is electronically delivered to the person accessing the site via one "electronic envelope."

¹³⁹ *Id.* at 43.

¹⁴⁰ S.E.C. Release No. 34-42728, *supra* note 3, at 83,376.

particulars of a given situation.¹⁴¹ According to the Release, an issuer's potential liability for embedding hyperlinks to analysts' reports falls under two separate areas: entanglement and adoption.¹⁴² But these concepts, however, are not set in stone.¹⁴³

According to the SEC, whether third-party analyst information hyperlinked to a company's Web site is imputable to such company depends upon whether the company has entangled itself in the preparation of the report, or has explicitly or implicitly ratified or approved the information.¹⁴⁴ The May 2000 Release reveals that in the case of issuer liability for statements by third-party analysts, the first line of scrutiny is the "entanglement" theory followed by the "adoption" theory.¹⁴⁵ The May 2000 Release establishes three non-exclusive factors to be used in determining whether third-party information hyperlinked to an issuer's site is imputable to the issuer under the entanglement or adoption standards: the context of the hyperlink; the risk of confusion to the investor; and the presentation of the hyperlinked information.¹⁴⁶

However, many felt that the May 2000 Release did not break significant new ground, and was therefore a disappointment to the securities industry.¹⁴⁷ Prior to the issuance of the May 2000 Release, the predominant standard for determining issuer liability pursuant to the federal securities laws for third-party reports had been the entanglement standard, discussed in part III, *supra*, which inquired as to whether the issuer "sufficiently entangled" itself with the analyst's report to the degree that the analyst's statements could fairly be imputed to the issuer.¹⁴⁸

¹⁴¹ SEC Approves Issuance of Interpretive Release on the Use of Electronic Media, *supra* note 5, at *2.

¹⁴² S.E.C. Release No. 34-42728, *supra* note 3, at 83,381.

¹⁴³ *Id.* at 83,381-382. In discussing the application of adoption and entanglement analysis to hyperlinks embedded on an issuer's Web site, the SEC states:

While the factors we discuss below form a useful framework of analysis, we caution that they are neither exclusive nor exhaustive. We are not establishing a "bright line" mechanical test. We do not mean to suggest that any single factor, standing alone, would or would not dictate the outcome of the analysis.

Id. See also SEC Discourages Web Hyperlinks: New Release Says Companies are Liable for Outside Mistakes, INVESTOR RELATIONS BUSINESS, 2000 WL 8692469 (May 15, 2000).

¹⁴⁴ S.E.C. Release No. 34-42728, *supra* note 3, at 83,381-382.

¹⁴⁵ *Id.* at 83,381.

¹⁴⁶ *Id.* at 83,382-383.

¹⁴⁷ 7/21/00 MONDAQ BUS. BRIEFING, 2000 WL 9238681 (July 21, 2000).

¹⁴⁸ Meister, *supra* note 31, at 948.

V. DISCUSSION

In theory, almost every informed securities lawyer would advise their corporate clients that Web sites simply should not include hyperlinks to analysts' reports.¹⁴⁹ In reality, however, numerous companies do just that.¹⁵⁰ Based upon the attendant risk of litigation, as well as the promulgation of swirling theories of liability surrounding an issuer's utilization of third-party analysts' reports in paper-form as a promotional and/or informational tool, the act of hyperlinking to such reports on an issuer's Web site is clearly an activity fraught with peril under the federal securities laws.¹⁵¹ Against this dangerous backdrop lies the irrevocable progression of technology, and the securities issuers' concomitant steadfast desire to employ such advancements for the betterment of their respective organizations.

Though the SEC has in recent years issued interpretive releases designed to better enable issuers to utilize such new technology,¹⁵² it has also advanced its desire to protect the investing public at large by reaffirming prior caselaw dealing with third-party analysts' reports.¹⁵³

Pursuant to the SEC's analysis that hyperlinking to third-party analysts' reports will be subject to entanglement and adoption

¹⁴⁹ Based upon the potential for liability as well as the uncertain SEC guidance and lack of court interpretation on the issue of issuer liability for hyperlinking to third-party analysts' reports, the prudent decision would be for securities lawyers to advise their corporate clients against inclusion of such hyperlinks.

¹⁵⁰ Michael J. Connell, *Preparation of Annual Disclosure Documents 2000: Corporate Web Sites*, 1161 PRAC. L. INST. 163, 171 (2000) (discussing corporate ignorance of SEC and expert admonishments to refrain from hyperlinking certain information to their Web sites).

¹⁵¹ The act of embedding hyperlinks to third-party analysts' reports exposes issuers not only to potential liability for material misstatements contained in such reports under Section 10(b) and Rule 10b-5 thereunder (thus including the application of the entanglement and adoption theories), but also to potential liability for gun-jumping or faulty prospectus issues under the '33 Act—under electronic envelope theory—where the issuer is in the process of offering securities for sale of the same class as that referred to in the third-party analyst report. Linda C. Quinn & Otilie L. Jarmel, *Securities Offerings: What Issuers & Underwriters' Counsel Need to Know Now: Securities Regulation and the Use of Electronic Media*, 1174 PRAC. L. INST. 123, 152 (2000).

¹⁵² In particular, S.E.C. Release No. 33-7233, *supra* note 136, and S.E.C. Release No. 34-42728, *supra* note 3.

¹⁵³ S.E.C. Release No. 34-42728, *supra* note 3, at 83,381 (affirming prior entanglement and adoption caselaw concerning issuer liability for the content of third-party analysts' reports). The SEC stated "[i]n the case of issuer liability for statements by third parties such as analysts, the courts and we have referred to the first line of inquiry as the 'entanglement' theory and the second as the 'adoption' theory." *Id.*

analysis, a discussion of the application of both theories to the process of hyperlinking is in order.¹⁵⁴

A. *Entanglement Analysis*

Under traditional *Elkind* entanglement analysis, discussed *supra*, the mere act of embedding a hyperlink to a third-party analysts' report in an issuer's Web site would not, without more, create liability under the federal securities laws.¹⁵⁵ Still, an issuer will be liable under entanglement theory, regardless of whether or not it embeds a hyperlink to third-party analysts' reports on its Web site, if that issuer's involvement with an analyst rises to the level of "sufficient entanglement" under *Elkind*.

B. *Adoption Analysis*

Issuers must be wary of their interaction with third-party analysts in the preparation of reports hyperlinked to their Web sites. Any minimal interaction with analysts combined with the act of embedding may prove more troublesome under adoption analysis.

The May 2000 SEC Release provides that whether an issuer has implicitly or explicitly adopted hyperlinked information, three non-exclusive factors should be considered: (1) the context of the hyperlink; (2) the risk of confusion to the investor; and (3) the

¹⁵⁴ *Id.* The SEC stated:

Whether third-party information is attributable to an issuer depends upon whether the issuer has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information. . . . In the case of hyperlinked information, liability under the "entanglement" theory would depend upon an issuer's level of pre-publication involvement in the preparation of the information. In contrast, liability under the "adoption" theory would depend upon whether, after its publication, an issuer, explicitly or implicitly, endorses or approves the hyperlinked information."

Id.

¹⁵⁵ This is so because, under *Elkind*, liability arises when an issuer "sufficiently entangles" itself with the preparation of a third-party analysts' report. *Elkind*, 635 F.2d at 163. Under *Elkind*, the liability-incurring activity therefore lies in the issuer's relationship with the analysts in preparing the report and not in the post-publication affirmative act of embedding a hyperlink. *See id.* An example of an activity which would trigger the entanglement standard would be a two-way flow of corrective and enhancing information between issuer and analyst prior to publication of the report, where such information were ultimately corroborated by the issuer prior to final publication of the report. *See In re Syntex Corp. Sec. Litig.*, 95 F.3d 922 (9th Cir. 1996). The mere act of hyperlinking, without a more substantial relationship between issuer and analyst in the preparation of material contained in the analysts' report, would assuredly not suffice to "sufficiently entangle" an issuer with a third-party analyst report.

presentation of the hyperlinked information.¹⁵⁶

1. Context of the Hyperlink

The context of the hyperlink, when examined as a component of adoption theory liability for hyperlinked third-party analyst reports, refers to appurtenant information included on an issuer's site regarding the veracity of information contained in the report, or the overall context in which the hyperlink is placed.¹⁵⁷

The May 2000 SEC Release also provides actual examples of when adoption under the contextual element would be deemed to occur, including where an issuer embeds a hyperlink in a document required to be filed or delivered pursuant to the initial or continuous disclosure requirements of the Securities Acts, where an issuer embeds hyperlinks while the issuer is still in registration and such action meets the '33 Act definition of "offer" or "offer for sale,"¹⁵⁸ or where the issuer includes textual information which indicates that the analyst report to which a hyperlink leads supports statements made by the issuer.¹⁵⁹

¹⁵⁶ S.E.C. Release No. 34-42728, *supra* note 3, at 83,381-383. See also Zammit & Gross, *supra* note 22, at 901; Jonathan E. Gottlieb & Diana R. de Brito, *The SEC's Long-Awaited "Internet Release" Answers Some Questions, but Leaves Others Untouched*, Cyber Securities Law, at http://www.cybersecuritieslaw.com/articles/gottlieb_electronic_delivery.htm (last visited Mar. 25, 2001); Michael R. Littenberg, *SEC Issues New Internet Release*, Schulte Roth & Zable, LLP, SECURITIES LAW/INTERNET June 2000, at <http://www.srz.com/sectemplate.asp?id=27> (last visited Mar. 25, 2001).

¹⁵⁷ Brian J. Lane, Bradford P. Weirick & Gillian McPhee, *Advanced Securities Law Workshop 2000: Electronic Communications and Internet Offerings*, 1194 PRAC. L. INST. 101, 150 (2000) (discussing issuer liability for hyperlinked information as set forth in the May 2000 SEC Release). For instance, if included under a heading connoting hyperlinks to which the issuer subscribes or approves of, an analysts' report may indeed be deemed to have been adopted by the issuer. S.E.C. Release No. 34-42728, *supra* note 3, at 83,382. Further, if such hyperlink is included in a portion of an issuer's Web site lauding third-party endorsements of the issuer and its business prospects, the mere inclusion of a hyperlink to a third-party analyst report may also be deemed an adoption of the contents of such report. *Id.*

¹⁵⁸ In which case a "strong inference" of adoption will arise. See *infra* note 167.

¹⁵⁹ S.E.C. Release No. 34-42728, *supra* note 3, at 83,382; Lane, Weirick & McPhee, *supra* note 157; Gottlieb & de Brito, *supra* note 156; Littenberg, *supra* note 156. S.E.C. Release No. 34-42728, *supra* note 3 states:

Whether third-party information to which an issuer has established a hyperlink is attributable to the issuer is likely to be influenced by what the issuer says about the hyperlink or what is implied by the context in which the issuer places the hyperlink. An issuer might explicitly endorse the hyperlinked information. For example, a hyperlink might be incorporated in or accompany a statement such as "XYZ's web site contains the best description of our business that is currently available." Likewise, a hyperlink might be used to suggest that the hyperlinked information supports a particular assertion on an issuer's web site. For

To ensure that the contextual element of adoption analysis is not present, issuers including hyperlinks to third-party analyst reports should not include any statements on their Web sites or supplemental materials that would connote its express or implied affiliation with, or subscription to, the information provided in the reports to which it has hyperlinked.¹⁶⁰

2. Risk of Investor Confusion

The SEC determines the risk of confusion to the investing public viewing a hyperlinked analyst report by the presence, or absence, of a meaningful cautionary statement accompanying the hyperlinking process in the form of an intermediary screen containing a disclaimer.¹⁶¹ Though not dispositive of an issuer's adoption or non-adoption of the contents of hyperlinked third-party analyst reports, the use of disclaimers "clearly and prominently" pronouncing that a viewer has left an issuer's site is an additional factor favoring the issuer under adoption analysis.¹⁶²

example, the hyperlink may be incorporated in or accompany a statement such as, "As reported in Today's Widget, our company is the leading producer of widgets worldwide." Moreover, even when an issuer remains silent about the hyperlink, the context nevertheless may imply that the hyperlinked information is attributable to the issuer. In the context of a document required to be filed or delivered under the federal securities laws, we believe that when an issuer embeds a hyperlink to a web site within the document, the issuer should always be deemed to be adopting the hyperlinked information. In addition, when an issuer is in registration, if the issuer establishes a hyperlink (that is not embedded within a disclosure document) from its web site to information that meets the definition of an "offer to sell," "offer for sale" or "offer" under Section 2(a)(3) of the Securities Act, a strong inference arises that the issuer has adopted that information for purposes of Section 10(b) of the Exchange Act and Rule 10b-5.

Id. at 83,382.

¹⁶⁰ Further, issuers should continually revisit any information contained on their Web site during registration, or contained in documents subject to initial and continuous disclosure requirements under the Securities Acts, as such hyperlinks will be presumed to be adoptive measures by the issuer of the information contained at the other end of such hyperlinks.

¹⁶¹ S.E.C. Release No. 34-42728, *supra* note 3, at 83,383. See also Lane, Weirick & McPhee, *supra* note 157; Gottlieb & de Brito, *supra* note 156; Littenberg, *supra* note 156 (discussing the risks of investor confusion about the existence or absence of a disclaimer attached to a hyperlinked analysts' report).

¹⁶² S.E.C. Release No. 34-42728, *supra* note 3, at 83,382. The SEC states:

Another factor we would consider in determining whether an issuer has adopted hyperlinked information is the presence or absence of precautions against investor confusion about the source of the information. Hyperlinked information on a third-party web site may be less likely to be attributed to an issuer if the issuer makes the

To avoid a finding that hyperlinking to third-party analyst reports poses a risk of confusion to investors, issuers desirous of embedding hyperlinks on their corporate Web sites should include gingerly worded disclaimers designed to inform the viewer, prior to their being transferred to the third-party analyst report, both that they are leaving the issuer's site and that the information about to be viewed is in no way that of the issuer.¹⁶³ Further, issuers would be shrewd to include further cautionary statements worthy of "bespeaks caution" protection¹⁶⁴ in order to deflect responsibility for any forward-looking projections included in the hyperlinked report. Such a prudently worded statement should, again, be provided to the viewer prior to their actual entrance to the third-party analysts' site.¹⁶⁵

information accessible only after a visitor to its web site has been presented with an intermediate screen that clearly and prominently indicates that the visitor is leaving the issuer's web site and that the information subsequently viewed is not the issuer's. Similarly, there may be less likelihood of confusion about whether an issuer has adopted hyperlinked information if the issuer ensures that access to the information is preceded or accompanied by a clear and prominent statement from the issuer disclaiming responsibility for, or endorsement of, the information. In contrast, the risk of investor confusion is higher when information on a third-party web site is framed or inlined. We are not suggesting, however, that statements and disclaimers will insulate an issuer from liability for hyperlinked information when the relevant facts and circumstances otherwise indicate that the issuer has adopted the information.

Id.

¹⁶³ Though the SEC does not view the use of disclaimers alone as sufficient to deflect liability for information made available to investors, whether through a hyperlink or otherwise, the use of such disclaimers was expressly cited by the SEC as a factor insinuating that liability is less likely to arise. S.E.C. Release No. 34-42728, *supra* note 3, at 86,304 n.61. The SEC stated:

We do not view a disclaimer alone as sufficient to insulate an issuer from responsibility for information that it makes available to investors whether through a hyperlink or otherwise. To conclude otherwise would permit unscrupulous issuers to make false or misleading statements available to investors without fear of liability as long as the information is accompanied by a disclaimer.

Id.

¹⁶⁴ As outlined in *In re Donald Trump Casino*, "bespeaks caution" protection will render immaterial as a matter of law any alleged omissions or misrepresentations contained in a statement otherwise attributable to an issuer provided a substantive cautionary statement, sufficiently tailored to specific future estimates or opinions, is provided to the investor. 7 F.3d at 371-72.

¹⁶⁵ The SEC explains that the provision of an "intermediate" screen would be a factor tending to disprove the existence of the risk of investor confusion. S.E.C. Release No. 34-42728, *supra* note 3, at 83,382. The "intermediate" nature of the screen would mean that any such disclaimer screen would need to be shown to the viewer prior to their entrance to the third-party analysts' site in order to conform to the SEC advisement. *Id.*

Beyond the SEC advisements, issuers may want to include certifications in the intermediary disclaimer screens in such a way as to prevent viewers from gaining access to the hyperlinked analyst reports until such time as the viewer acknowledges, by perhaps clicking their mouse on an "O.K." button, that they have read and fully understand the disclaimer provided them.¹⁶⁶

3. Presentation of the Hyperlinked Information

The presentation of hyperlinked information is also a determinative factor in adoption analysis.¹⁶⁷ Under this component of the adoption inquiry, the relevant analysis looks to whether the issuer has provided a hyperlink to only selected analysts, and thereby implicitly adopts the unique analysis of the issuer therein provided as opposed to alternate reports not hyperlinked to the issuer's site.¹⁶⁸ In addition, temporary establishment of hyperlinks to third-party analysts' reports may be indicative of an adoption of the information provided at the other end, because such action may be viewed as an attempt on the part of the issuer to control information flowing from hyperlinked sites.¹⁶⁹ This element also regards the layout of the issuer's Web site as a factor determining whether or not adoption has occurred, in that any attempt to draw a viewer's attention to a particular hyperlink, whether by use of color or text or otherwise, may be viewed as an adoption of the hyperlinked information.¹⁷⁰

¹⁶⁶ Such an additional process would further negate the claim of risk of investor confusion in that the affirmative act of an investor clicking on button certifying that they are aware that they are leaving the issuer's site would tend to disprove any subsequent claim of investor confusion. *Id.*

¹⁶⁷ S.E.C. Release No. 34-42728, *supra* note 3, at 83,383; Lane, Weirick & McPhee, *supra* note 157; Gottlieb & de Brito, *supra* note 156; Littenberg, *supra* note 156.

¹⁶⁸ S.E.C. Release No. 34-42728, *supra* note 3, at 83,383 (discussing how issuer attempts to divert viewer attention to a particular link may be viewed as an adoption of the statements contained in such report).

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* The SEC states:

The presentation of the hyperlinked information by an issuer is relevant in determining whether the issuer has adopted the information. For example, an issuer's efforts to direct an investor's attention to particular information by selectively providing hyperlinks is a relevant consideration in determining whether the information so hyperlinked has been adopted by the issuer. Where a wealth of information as to a particular matter is available, and where the information accessed by the hyperlink is not representative of the available information, an issuer's creation and maintenance of the hyperlink could be an endorsement of the selected information. Similarly, an issuer that selectively establishes and terminates hyperlinks to third-party web sites depending upon the nature of the

To be certain that the presentation of hyperlinked information does not rise to the level of an adoption of such information, issuers should not selectively include links to third-party analyst reports.¹⁷¹ If one such report is hyperlinked, issuers should include all such analyst reports, both positive and negative, to ensure that their inclusion will not be viewed as a selective endorsement by the issuer.¹⁷²

C. *Post-Publication Ratification Analysis*

Where such adoption analysis is applied as a post-publication ratification theory, as in *Presstek*,¹⁷³ the exposure attendant with hyperlinking to third-party analysts' reports is at its most treacherous.¹⁷⁴ Though not explicitly referred to in the May 2000 Release, post-publication ratification liability under the adoption

information about the issuer on a particular site or sites may be viewed as attempting to control the flow of information to investors. Again, this suggests that the issuer has adopted the information during the periods that the hyperlink is operative. Finally, the layout of the screen containing a hyperlink is relevant in determining whether an issuer will be deemed to have adopted hyperlinked information. Any action to differentiate a particular hyperlink from other hyperlinks on an issuer's web site, through its prominence, size or location, or to draw an investor's attention to the hyperlink, may suggest that the issuer favors the hyperlinked information over other information available to the investor on or through the site. For example, a particular hyperlink might be presented in a different color, type font or size from other hyperlinks on an issuer's web site. Where the method of presenting the hyperlink influences disproportionately an investor's decision to view third-party information, the hyperlinked information is more likely attributable to an issuer.

Id.

¹⁷¹ The SEC has specified that selectively providing hyperlinks is a relevant factor in considering whether an issuer has endorsed a specific third-party analysts' report to the exclusion of other such reports. *Id.*

¹⁷² Nor should an issuer temporarily allow hyperlink access to a third-party analyst report. Once access is granted via the hyperlink, an issuer should include the hyperlink until such time as the issuer reasonably believes that the information on the other end has become materially false or misleading, at which time the issuer should include an explanation in lieu of such hyperlink as to the rationale for its removal. Further, if the issuer does so include a hyperlink to third-party analyst reports, no special fonts, colors, or words of puffery should be included near the hyperlink. Indeed, all such reports should be tightly grouped in one area of the issuer's site free from garrulous text.

¹⁷³ *Presstek*, 1997 WL 784548 at *10.

¹⁷⁴ Primarily because the mere act of embedding a hyperlink to an analysts' report in an issuer's site, in and of itself, may be deemed by the SEC or a court to be a ratifying event significant of the issuer's affirmative view of the contents of such report. The act of hyperlinking thus may be deemed to be a distribution of the contents of such report akin to the distribution of the report in *Presstek* giving rise to liability for the contents of such report. See *id.* at *11.

theory as espoused in *Presstek*,¹⁷⁵ would pose monumental problems for securities issuers coveting hyperlink inclusion.¹⁷⁶ Though the SEC remained silent in the May 2000 Release on whether the mere act of an issuer in embedding a hyperlink to a third-party analyst report constitutes "distribution" under *Presstek*, one would not be unwise to envision just such an analysis.¹⁷⁷

Without further clarification by the SEC, or by the courts, issuers must be extremely cautious in including hyperlinks to third-party analysts reports for fear that such an action, in and of itself, may be deemed to be distributing the analyst report and thus ratifying its contents under *Presstek*. Even if an issuer were to think itself diligent, and steadfastly review any reports to which it linked itself to ensure that the contents were in no way false or misleading, it may inadvertently be exposing itself to even more liability.¹⁷⁸ Therefore, should the *Presstek* analysis be applied to hyperlinking to third-party analyst reports, issuers who dare to hyperlink to third-party analyst reports may be creating a circuitous route to liability under the federal securities laws.

¹⁷⁵ *Presstek*, 1997 WL 784548 at *10.

¹⁷⁶ The SEC analysis in the May 2000 Release specifically provides that adoption liability for hyperlinked information is non-exclusive. Thus, the danger is that *Presstek* liability for ratification of faulty third-party analyst reports may attach to analyst reports hyperlinked to issuers sites. The broad analysis used by the SEC in *Presstek* would attach liability to any issuer, regardless of the existence or non-existence of pre-publication entanglement, where such issuer knowingly or recklessly distributes false or misleading third-party analyst reports.

¹⁷⁷ The SEC has previously stated, in its October 1995 Release, that information may be electronically delivered to customers. Further, the SEC avowed in the May 2000 Release that hyperlinks included in documents required to be filed will be automatically deemed to adopt and incorporate the hyperlinked information. S.E.C. Release No. 34-42728, *supra* note 3, at 83,381.

¹⁷⁸ This is because the act of reviewing third-party analyst reports in itself may be viewed by the SEC as an adoptive or ratifying action and the issuer, in attempting to protect itself from liability, may in fact be inducing liability. Further, upon reviewing such third-party reports, the issuer may have the duty to update or correct any information contained therein. Once a company reviews one such report, it surely must review all such reports, or else chance violating the selective disclosure element of adoption liability should the issuer choose to hyperlink only those reports which it deems to be accurate. S.E.C. Release No. 34-42728, *supra* note 3, at 83,382. And again, once any information were found to be inaccurate, pursuant to Regulation FD, if the issuer were to provide information to the third-party analyst in an attempt to correct the contents of the report, it would be required to immediately or within a reasonable time disclose such correction to the public. SEC Release, *supra* note 96.

CONCLUSION

If the mere relationship between an issuer and an analyst is truly a fencing match conducted on a tightrope, then the decision to embed a hyperlink within an issuer's Web site to third-party analysts' reports may best be described as the same match conducted blindfolded while standing on one's hands and simultaneously reciting Homer's *Odyssey* in Pig Latin. The danger inherent in such a decision is amplified by the uncertainty to which courts and the SEC may apply the federal securities laws. Securities issuers should therefore be exceptionally deliberate in deciding whether or not to embed hyperlinks to third-party analyst reports.

Until further elucidation is provided by either the courts or the SEC, issuers may be wise to omit hyperlinks to third-party analyst reports altogether, or at the very least include painstakingly drafted disclaimers as intermediary attachments to all such hyperlinks.